S. HRG. 110–568

THE GOOGLE–YAHOO! AGREEMENT AND THE FUTURE OF INTERNET ADVERTISING

HEARING

BEFORE THE

SUBCOMMITTEE ON ANTITRUST, COMPETITION POLICY AND CONSUMER RIGHTS

OF THE

COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE

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THE GOOGLE–YAHOO! AGREEMENT AND THE FUTURE OF INTERNET ADVERTISING

TUESDAY, JULY 15, 2008

U.S. SENATE,
SUBCOMMITTEE ON ANTITRUST, COMPETITION POLICY AND CONSUMER RIGHTS,
COMMITTEE ON THE JUDICIARY,
Washington, D.C.

The Subcommittee met, pursuant to notice, at 10:31 a.m., in room SD–226, Dirksen Senate Office Building, Hon. Herb Kohl, Chairman of the Subcommittee, presiding.

Present: Senators Kohl, Leahy, Schumer, Cardin, Hatch, and Specter.

OPENING STATEMENT OF HON. HERB KOHL, A U.S. SENATOR FROM THE STATE OF WISCONSIN

Chairman KOHL. We will call this hearing to order at this time.

Today we are going to examine the Internet advertising market. We have read daily news accounts of Microsoft's efforts to buy all or part of Yahoo! and proxy wars being fought for control of Yahoo!'s future.

No one knows the outcome of those events, but today we will examine what we do know. Google and Yahoo!, the two largest competitors in search-based advertising, have reached an agreement where Yahoo! will outsource a portion of its advertising business to Google and the two companies will split the proceeds. Yahoo! contends that this will add $800 million annually and enable them to become a stronger independent competitor to Google. Critics, on the other hand, ask how the agreement could possibly be good for competition. They argue that Google is paying its largest competitor a premium not to compete as vigorously as Yahoo! had previously. And the higher ad rates it will earn will encourage Yahoo! to compete even less. So we are forced to ask today whether this agreement will reduce Yahoo! to nothing more than the newest satellite in the Google orbit.

While we will need to study this deal carefully, what is indisputable is the vital importance of Internet advertising to the national economy. As we increasingly rely on the Internet for commerce, entertainment, communication, and news, advertising on the Internet has become ever more essential to business. In 2007, more than $21 billion was spent on Internet advertising in the United States, more than the amount spent on advertising on cable television, broadcast TV networks, radio, or billboards. And it has tripled in just the last 5 years.

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Google, Yahoo!, and Microsoft perform essential functions. Not only do they serve as gateways to the Internet, but in doing so, they help businesses and consumers find each other with the most relevant advertising ever seen. So the stakes are very high in maintaining a vibrant and competitive Internet advertising sector. One type of Internet advertising, the advertising that is displayed with Internet searches, is particularly impacted by the Google/Yahoo! deal. The two companies together have a 90-percent market share in Internet search advertising, with Google alone controlling more than 70 percent of that market. In examining the competitive impact of this deal, we will need to find answers to a number of important questions: What will be the effect of Yahoo! outsourcing a portion of its search advertising to its biggest competitor? Will it lead to higher advertising rates or will it work to advertisers' benefit by giving them a bigger audience? Do other types of Internet advertising factor into this equation?

The history of the development of the computer industry gives us reason to be cautious as we evaluate this deal. A decade ago, today's witness Microsoft came dangerously close to quashing competition throughout the high-tech economy. We are pleased that Microsoft has reformed its business practices, but this experience teaches us the importance of acting and acting early to ensure that competition is preserved in this vital sector of the economy.

[The prepared statement of Senator Kohl appears as a submission for the record.]

I turn now to Senator Arlen Specter for any comments.

STATEMENT OF HON. ARLEN SPECTER, A U.S. SENATOR FROM THE STATE OF PENNSYLVANIA

Senator SPECTER. Well, thank you, Mr. Chairman. This is a very important hearing. The Internet has come to be such a major factor in our communications, very, very important, and we are dealing here with some of the giants in the field. The agreement would give Yahoo! the option to display Google ads on its side of the search results, non-exclusive. And there are a lot of ramifications. As noted over the weekend, Microsoft, with the support of Yahoo!'s shareholder Carl Icahn, made yet another offer to acquire Yahoo! but Yahoo! declined. Now it is reported that Mr. Icahn will mount a proxy fight at the August 1st Yahoo! shareholders meeting in an effort to complete a deal with Microsoft.

We are really in such a transitional age, it is hard to keep up with all of the technical advances. And it is a point of amazement to me to open up the Internet and put in the name of Senator Pat Leahy or Senator Herbert Kohl or my own name and see the splash of information that comes out. And high-tech and advertising have become the order of the day. And then when you have the entry into the field of people like Mr. Icahn, proxy fights, it is a little hard to understand all of what is going on.

Let me particularly commend Senator Kohl. Among the four of us here, he is the only non-lawyer. That has come to be an advantage in the U.S. Senate. It clears the head. He looks at these issues from a little different perspective, not burdened with all the antitrust courses which Senator Leahy took at Georgetown and Senator

Schumer took at Harvard. And it is fortunate to have that kind of a perspective on this kind of an issue. So good work.

Chairman KOHL. Thank you, Senator Specter.

Senator Leahy, would you like to make a few comments?

STATEMENT OF HON. PATRICK J. LEAHY, A U.S. SENATOR FROM THE STATE OF VERMONT

Senator LEAHY. Well, I must admit when I see Senator Specter saying about clearing one's head not being a lawyer, I recall once when scuba diving with my wife, and this 9-foot nurse shark, the largest one we had ever seen, usually harmless—that is the operative word, "usually." It came shooting right at us. We kind of ducked. It went right over us and thought, That is great, it left. It turned around and it comes right back at us. I was sucking in so much air, I thought maybe the tanks would collapse. And we got back on the boat, and I said to my wife, who is a registered nurse, I said, "Well, don't worry, dear. That shark gave you professional courtesy because a nurse shark, you are a nurse." She said, "No, darling. You are a lawyer. The shark gave you professional courtesy."

[Laughter.]

Senator LEAHY. But I do enjoy seeing the information, and once in a while it is accurate that you read about each other. And once in a while it is not. But I think the point that has been made by both Senator Kohl—and I compliment him for holding this hearing—and Senator Specter is that the Internet opens new means of communication, new ways to buy and sell products, all the things you all know better than anybody else. And that free and easily accessed content on the Internet, especially the free content, is being driven by a successful and competitive online advertising industry. We would not have it without that.

The online advertising industry in the U.S. I understood surpassed $21 billion last year. That is something everybody thought was an experiment just a few years ago, one of the fastest growing areas. And more and more people are using the Internet—business, schools, my 10-year-old grandson who goes on to check his school schedule and things like that. And more and more people are going to try to move their messages online.

Now, the question for us here is whether these advertisers—and it could be Orvis or the Vermont Teddy Bear Company, thinking about companies in my own State, or it could be a major corporation like an auto company or something like that—will find options at competitive prices because the business there is dynamic. The antitrust laws, rooted as they are in the fundamentals of competition in innovation and pricing, are nimble enough to keep up with changing business models and technology.

But we have this drama being played out in the courting of Yahoo! by both Microsoft and Google, and that is going to have lasting effects. The Google agreement with Yahoo! may relate only to text advertisements, but if it stifles competition in this market, that will quickly spill into emerging online ad markets such as delivery to mobile systems, telephones and others.

The ability of a single company to dominate the online advertising marketplace also raises the specter that one company will accumulate vast amounts of personal viewing data. That worries me as much as any one item. It worries me whether it is private industry doing it or whether it is our Government doing it because of the privacy concerns. This is an issue I am going to remain focused on as the online advertising market continues to develop.

Senator Specter and I held a hearing about the gathering of information within the data bases in the Federal Government on this and how the Antitrust Subcommittee has taken a leading role in looking at the competition issues. And I really want to thank Senator Kohl for staying vigilant on this. When he told me he was holding this timely and important hearing, I thought it was a great idea.

I will hold off and listen to the witnesses, and thank you, Herb.

[The prepared statement of Senator Leahy appears as a submission for the record.]

Chairman KOHL. Thank you very much, Senator Leahy.

Senator Hatch?

STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM THE STATE OF UTAH

Senator HATCH. Well, thank you, Mr. Chairman. I welcome all of you witnesses here today. This is a very important set of issues, as you know, and I could outline them, but I am sure everybody knows what we are talking about or at least has some idea. We want to take every consideration here that we can. These involve tremendous entities that do tremendous things in our society, and there are tremendous antitrust issues involved.

So I just want you to know I take a great deal of interest in this, and as my colleagues will, and I hope that we can arrive at the right conclusions. But we are grateful to have all of you here to help enlighten us here today, and we look forward to hearing your testimony.

Thank you, Mr. Chairman.

Chairman KOHL. Thank you very much, Senator Hatch.

Senator Schumer?

STATEMENT OF HON. CHARLES E. SCHUMER, A U.S. SENATOR FROM THE STATE OF NEW YORK

Senator SCHUMER. Well, thank you, Mr. Chairman, and first let me join my colleagues in just thanking you for being such a diligent and conscientious Chair of this Subcommittee, on which I am proud to serve, and making sure that there is an antitrust law here and it is vibrant and active and important. And I also want to thank all the witnesses for coming today to talk with the Subcommittee. I care a lot about this issue. You know, the Internet is developing every day, changes. It is exciting to be sort of at the beginning of laying a whole new way that people communicate and that changes all the time. And our job here, because changes now may affect things 20, 30, 50 years into the future, is to make sure it stays as competitive and as consumer friendly as possible.

And second, of course, I have a parochial interest. Internet advertising is a large industry in New York and a growing industry in New York, and we in New York base some of our future on that industry. We cannot just rely on one industry.

And so for all those reasons, I am interested, and that is why I have followed developments in this industry closely over the last few years. I want to commend the companies testifying for maintaining a robust public debate on some of the most important issues in this critical sector.

Yahoo! and Google have consistently moved the debate forward and have been fierce competitors. And for the most part, consumers have benefited as a result. And let me say this: Regardless of whatever happens with this deal, I am confident that Yahoo! and Google will wake up the next morning and prepare for the next battle. I am not concerned that this deal will spell the end of either company. But what I am concerned about is whether this deal is good for everyday Internet users. That is really what the Internet is all about: connecting each citizen on his or her own to information and commerce more efficiently than was ever possible before. And I feel confident, Mr. Chairman, that this arrangement could well result in Internet advertising that is more tailored to Internet users' wants and needs. And I also appreciate the reassurances from Google and Yahoo! about what they will to protect consumer privacy, and, of course, we will be watching, I know, under Chairman Leahy's watchful eye to make sure that those pledges are followed through.

I am also sensitive to two of the antitrust concerns that have been raised. I hope this arrangement will not lead to a price floor or any unlawful price fixing for search advertising, as some have alleged. And I hope that this deal will not stifle Yahoo!'s development in the field.

So I look forward to the testimony. I thank you for having the hearing, Mr. Chairman, and I know we will continue to follow this very important and really seminal issue.

Chairman KOHL. Thank you very much, Senator Schumer.

We would like now to introduce our panel of witnesses. Our first witness today will be Michael Callahan. Mr. Callahan is the General Counsel for Yahoo!, where he has worked since 1999. Prior to joining Yahoo!, Mr. Callahan held positions with Electronics for Imaging, Inc., and the law firm of Skadden Arps.

Following him will be David Drummond. Mr. Drummond is the Senior Vice President for Corporate Development and Chief Legal Officer at Google. In this role, Mr. Drummond works with management teams at Google to evaluate new business opportunities, including alliances and mergers.

Next we will be hearing from Brad Smith. Mr. Smith is the Senior Vice President and General Counsel for Microsoft. While at Microsoft, Mr. Smith has played a leading role in the company's intellectual property, competition, and other public policy issues. He also served as Microsoft's Chief Compliance Officer.

Following him we will be hearing from Tim Carter. Mr. Carter is a master carpenter and plumber as well as syndicated columnist on building. He is the founder of AsktheBuilder.com, an online resource for building and home repair.

And then we will be hearing from Matthew Crowley. Mr. Crowley is the Chief Marketing Officer for AT&T's Yellowpages.com. Prior to his position with Yellowpages.com, Mr. Crowley worked at SBC's SmartPages.com and Pacific Bell Smart Yellowpages.

We thank you all for appearing before this Subcommittee. I remind you all please to limit your opening testimony to 5 minutes.

Now I ask all of you to stand and take the oath with your right hand raised. Do you affirm that the testimony you are about to give will be the truth, the whole truth, and nothing but the truth, so help you God?

Mr. CALLAHAN. I do.

Mr. DRUMMOND. I do.

Mr. SMITH. I do.

Mr. CARTER. I do.

Mr. CROWLEY. I do.

Chairman KOHL. Thank you so much.

Mr. Callahan, we would be delighted to hear from you.

STATEMENT OF MICHAEL J. CALLAHAN, EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL, YAHOO! INC., SUNNYVALE, CALIFORNIA

Mr. CALLAHAN. Thank you, Chairman Kohl, Ranking Member Hatch, and members of the Subcommittee. My name is Michael Callahan, and I am Executive Vice President and General Counsel of Yahoo! Inc. I appreciate the opportunity to be here today to discuss the dynamic and growing Internet advertising space and the commercial agreement between Google and Yahoo!.

Yahoo! welcomes this hearing, and we are confident that the more one learns about this agreement, the more clear it becomes that it is good for competition—good for consumers, good for advertisers, and yes, good for Yahoo!.

The purpose of this commercial arrangement and the intent of Yahoo! moving forward is to help make our company an even stronger competitor to Google, to Microsoft, and to others in the dynamic and rapidly growing online advertising world. As I am sure you know, this has been an interesting time for our company, to say the least.

While I don't want to dwell on the very public proxy fight in which we are currently engaged, I do want to spend a brief moment on it because it will give you a flavor for how intensely competitive the search business has become. All of the companies at this table are laser focused on being significant players in search. With this business arrangement, Yahoo! will continue to execute on its long-term corporate strategy. Microsoft, on the other hand, has turned to activist shareholder Carl Icahn, in the apparent hope that this will force a fire sale of Yahoo!'s core strategic search business.

Our priority at Yahoo! is to build value for our stockholders. That continues to be our core mission. What we will not do, however, is allow our business to be dismantled or sold off piecemeal on terms that would be disadvantageous to Yahoo! stockholders and to the market as a whole. I trust that this will give you context to understand the extraordinary value we all place in the paid search portion of the online advertising business and how very competitive it is and will remain, and why there are so many misconceptions—advanced by our competitors—about the agreement we have entered into with Google.

Let's start by reviewing what this agreement is not as well as what it is.

First, this is not a merger. Far from it. We will increasingly compete with Google and they with us. This is a commercial arrangement between two companies who will remain autonomous and compete aggressively-in search and display advertising, mobile, news, e-mail, finance—you name it. Yahoo! is here to stay, and we intend to compete across countless platforms, including search, for years to come.

Second, Yahoo! is not exiting search, nor are we ceding any portion of that space to Google. This will not, as some claim, result in Google controlling 90 percent of the search business. To the contrary, we will continue to do everything we can to grow our share and also strengthen our competitiveness in search and search advertising. This deal is just one more important step along that path, and with all due respect to Google, we have every intention of fighting them and winning—in this and in other areas—for years to come.

Furthermore, this agreement does not affect algorithmic search at all. When a user comes to Yahoo! and performs a search, the algorithmic results returned will still be entirely Yahoo!'s. Yahoo! serves close to a quarter of the searches that consumers make today, and we expect to be serving that or more after this deal is implemented.

Third, this agreement is non-exclusive and gives Yahoo! complete discretion over how, where, and when we will choose to use Google advertising on our sites. There are no minimum requirements either, and Yahoo! is free to make similar deals with other companies. In other words, this gives Yahoo! the option to show Google ads, but does not tie our hands in any important respect.

Fourth, the claim some have made that Yahoo! and Google are price-fixing is entirely false. Prices for search terms are set by open and fair market-based auctions, and advertisers only pay when consumers click on their ads.

This agreement is truly win-win. It benefits consumers, advertisers, publishers, and Yahoo!. Consumers will now get more relevant advertising on Yahoo!'s site. Advertisers will reach more consumers, and Yahoo! will become an even stronger competitor in the broad advertising marketplace.

To put this agreement in perspective, it is helpful to recall that until 2004 Yahoo! completely outsourced both its algorithmic and sponsored search to a variety of companies, including algorithmic search to Google. More recently, other companies had outsourced their search functions to Yahoo!. In fact, Microsoft outsourced its sponsored search to Yahoo! just a few years ago and still does in some places around the world.

In 2004, Yahoo! made the strategic decision to bring algorithmic and sponsored search in-house, and that decision has not changed. Since then we have invested hundreds of millions of dollars to improve our search products and compete better in the marketplace.

For example, just last week, we announced BOSS, an open platform build-your-own search service, which we believe will unleash a wave of innovation, and our efforts to create an open, robust exchange to bring publishers and advertisers together are also well on their way. These efforts are consistent with our complete commitment to continued growth in search and display advertising.

With the additional operating cash-flow from this agreement—anticipated to be between $250 million and $450 million in the first year—Yahoo! will accelerate our innovation and better compete against Google, Microsoft, and others in the online advertising marketplace.

Over the coming weeks, Yahoo! will continue to work with our advertisers, our users, outside groups, and government authorities to explain this agreement and address any questions about the facts of the arrangement. We have kept the Department of Justice informed along the way and will continue to cooperate with them and this Subcommittee. We are confident that the more one knows about this agreement, the more it becomes clear that it will increase competition, stimulate creativity, and benefit consumers, advertisers, and the online advertising industry overall.

Thank you again for inviting me to appear here today, and I look forward to answering any questions you may have.

[The prepared statement of Mr. Callahan appears as a submission for the record.]

Chairman KOHL. Thank you, Mr. Callahan.

Now we will hear from the Google representative with us today, Mr. Drummond.

STATEMENT OF DAVID DRUMMOND, SENIOR VICE PRESIDENT OF CORPORATE DEVELOPMENT, AND CHIEF LEGAL OFFICER, GOOGLE, MOUNTAIN VIEW, CALIFORNIA

Mr. DRUMMOND. Thank you, Chairman Kohl, Senator Hatch, members of the Subcommittee. Thanks very much for inviting me here today.

The Internet is a dynamic, competitive environment due to the openness that has always been its hallmark. Our non-exclusive commercial agreement with Yahoo! will maintain and expand that competition. It creates new efficiencies that will benefit consumers, advertisers, and publishers, while protecting privacy and spurring innovation.

When Yahoo! chooses to use our technology, consumers will see more relevant ads that better connect them to the products and services they are interested in. Advertisers will benefit from better ad-matching capability, improving the way that they reach their customers. And web publishers who place Yahoo!'s ads on their sites will also see more revenue from better ad matching. That is why large and small advertisers, ad agencies, and publishers have expressed their support for this agreement, including such names as Publicis, Digitas, Overstock, and even Microsoft's own in-house ad firm, Avenue A/Razorfish, who called it "good news for advertisers."

Now, the fundamental point I would like to make today is that this agreement promotes ongoing competition among advertising. Let there be no doubt about this point. Google and Yahoo! will remain fierce competitors—in search, in online advertising, and many other products and services. Yahoo! has said that it will reinvest revenue from this agreement into improving its search engine and its other services. This continued competition will help fuel innovation that is good for the Internet, good for Internet users, and good for the economy.

Now, the fact that this arrangement is made between competitors is not unusual. Commercial arrangements between competitors are commonplace online and in many other industries. Antitrust authorities have recognized that consumers can benefit from these arrangements, especially when one company has technical expertise that enables another one to improve their product quality. And we are also excited that as part of this agreement, Yahoo! will make its instant messaging network interoperable with Google's. That is a big step forward, making instant messaging more like e-mail, with users able to communicate across platforms more easily.

Now, I would also like to clear up a few things about this agreement.

First, unlike the other alternatives, such as Microsoft acquiring Yahoo!'s search assets or taking over all of Yahoo!, this agreement will not remove a player from the field, from the competitive field. Yahoo! will remain in the search advertising business and will continue to be a vigorous and aggressive competitor.

Now, some would also have you believe that the agreement will result in Google controlling nearly all of search advertising. The agreement does no such thing. Yahoo! will continue to operate its own search platforms, so adds to its longstanding and deep base of advertisers, and continue to operate its own ad auction. The agreement merely gives them the option to show Google ads in cases where Google ads are likely to generate more value. It is important to note also that this agreement is limited to the U.S. and Canada and excludes emerging fields such as mobile.

Second, the agreement does not increase Google's share of search traffic because Yahoo! will continue to run its own search engine. So, simply put, Yahoo! will have every incentive, as you heard from Mr. Callahan they have every intention, to continue to expand their search advertising business.

Third, the agreement will not set an illegal price floor. Microsoft would have you believe that the additional revenue that Yahoo! and Google might make from the agreement will come solely as a result of increased advertising prices. Nothing could be further from the truth, and this reflects a fundamental misunderstanding of how search monetization actually works. The fact is we expect that the primary driver of additional revenue will be more relevant ads being delivered to more users, who will then click on those ads in greater numbers. In other words, we are not looking to sell ads at higher prices. We are looking to sell more ads. This is good for everyone. Users are going to see more relevant ads. Advertisers will connect with more interested users, and Yahoo! and its partners will sell more advertising space.

Fourth, the agreement also upholds Google's deeply held commitment to protecting user privacy. As Google supplies ads to Yahoo! and its partners, personally identifiable information of Internet users will not be shared between the companies.

So let me conclude today with some frank talk about what is going on here. The most energetic critic of this agreement is Microsoft, who, of course, is a significant competitor of ours and not exactly a mom-and-pop shop. This is the same Microsoft whose CEO said he was going to "kill Google" along with a lot of other salty language I cannot repeat in this setting. And it is also the same

Microsoft that has a 90-percent share of operating systems, a 90-percent share of productivity software, and an 80-percent share of the browser market—a desktop monopoly that Microsoft could use to harm the next phase of the Internet, namely, cloud computing. Most importantly, this is the same Microsoft that is actively trying to buy or at least destabilize Yahoo!, thereby eliminating one of its biggest competitors.

Now, if you think all of that gives Microsoft an incentive to oppose this agreement, you would be right. And let's also remember that Microsoft came before this Committee 10 months ago with a host of extremely dramatic arguments about our acquisition of DoubleClick, even though they themselves had recently acquired DoubleClick's largest competitor. The regulatory agencies were right to reject Microsoft's arguments then, and they will be right to reject them again.

So, in conclusion, openness, interoperability, and competition are central to Google's culture, the vibrancy of the Internet, and the growth of free markets. Unlike with the desktop, competition on the Internet is always just a click away.

Thanks, and I look forward to taking your questions.

[The prepared statement of Mr. Drummond appears as a submission for the record.]

Chairman KOHL. Thank you very much, Mr. Drummond.

We will now hear from your good friend at Microsoft, Mr. Smith. [Laughter.]

Senator LEAHY. He may differ.

STATEMENT OF BRAD SMITH, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, MICROSOFT, REDMOND, WASHINGTON

Mr. SMITH. Thank you for the introduction by my colleagues at the table. Thank you Senator Kohl, Senator Hatch, other members of the Subcommittee.

Let me be the first to acknowledge that Microsoft is not disinterested when it comes to the issues before this Committee. No competitor ever is. None of us are disinterested. But we do know a lot about this market, and using that information, we can help identify the questions that are important for reviewing this agreement.

I think the principal question is this: Can a single company establish effective control of the pricing of 90 percent of the market for search advertising by entering into an agreement with its single largest competitor?

Now, the technology is complicated, but the antitrust issues are straightforward. That is what I would like to address this morning.

First, search has become the gateway to the web. Many Americans sit down at a computer, and the first thing they look at is a search page. When they get the results, they use those results to determine what else they are going to look at or perhaps use or buy from a company across the country.

Search advertising has become the fuel that is supporting a lot of the content on the Internet today, as Senator Leahy referred to earlier. It may be a sports score, it may be a news story, it may be entertainment; but all of this free content is frequently paid for, including by search advertising. It has become a very large market.

By 2011, it is estimated that the market for search advertising will exceed $16 billion. That will come close to rivaling the $20 billion that is paid today on all advertising for all cable television across the country.

We believe the Internet today is at a moment of historical importance in its evolution. If you look at the market for search advertising, there are three principal competitors: Google has 70 percent of this market, Yahoo! has 20 percent, and Microsoft has less than 10 percent. So the fundamental question is: What effect will this new agreement between Yahoo! and Google have on the future of competition on the Internet? We believe the effects will be four-fold.

First, it will lead to an unprecedented level of concentration when it comes to search advertising. In the history of advertising, no single company has managed to take control of pricing of 90 percent of all of the advertising in any medium—not in television, not in radio, not in publishing. It should not happen on the Internet.

Second, this is going to mean fewer choices for advertisers. Today there are many advertisers that choose to advertise on Yahoo! either instead of or in addition to advertising on Google. And yet under this agreement, many of these advertisers are going to lose that choice. They are going to have to go buy ads from Google simply to get the very same ad placed in the very same place on a Yahoo! search page.

Third, this agreement will mean higher prices. The whole basis for this agreement is the opportunity for Yahoo! to raise its prices. When Yahoo! has filed its statements with the Securities and Exchange Commission, it has referred to the opportunity for "better monetization." Mostly that is a fancy way of describing a price increase. When Yahoo! says it sees an $800 million opportunity to increase revenue, that is money that is going to come out of the pockets of American companies, large and small, companies that are buying cheaper ads on Yahoo! today.

Finally, this agreement does raise important questions for privacy. It is not just what is shared between the companies, but what information flows from users to Google. If search is the gateway to the web, as most believe it is, then this agreement creates the prospect of a single company—Google—taking control of that gateway. It raises the prospect of information from up to 90 percent of search advertising flowing to Google.

If this agreement goes forward, this Congress may not need to enact a Federal privacy policy. We will have a national privacy policy. It will be Google's privacy policy.

So, in sum, let me say we acknowledge that this technology continues to change rapidly, but for 118 years, since the Sherman Act was enacted, one rule of the road has remained constant. We are all encouraged to work harder in order to succeed. We are all encouraged to offer consumers a better product. But no one is permitted to buy control of up to 90 percent of the market by entering into an agreement with its single largest competitor. The question before this Congress, and indeed the Department of Justice and the country as a whole, is whether that principle should be abandoned now.

Thank you.

[The prepared statement of Mr. Smith appears as a submission for the record.]

Chairman KOHL. Thank you, Mr. Smith.

Mr. Carter?

STATEMENT OF TIM CARTER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, ASKTHEBUILDER.COM, CINCINNATI, OHIO

Mr. CARTER. Chairman Kohl, Ranking Member Hatch, and other members of the Subcommittee, I sincerely appreciate this to address you about this very important topic.

The future of Internet advertising is brilliant. In fact, some might say it is possibly one of the fastest growing segments of our national economy. The proposed agreement between Google and Yahoo!, as seen from my eyes as a consumer and an Internet publisher, is a very good idea. There are many more winners who benefit from this business transaction than those who make claims about being harmed.

People like you and me have problems each day. We seek out solutions to those problems, and with the advent of the Internet, it has never been easier or faster to discover precise and accurate solutions to those problems.

In my opinion, one of the reasons for Google's success stems from the fact they are an excellent matchmaker. They created a streamlined search engine that displays search results as well as contextual advertising that matches the exact search term typed by tens of millions of consumers each day, many of whom are your constituents. Google is not the sole search engine that does this.

The advertising that is part of the search results is purchased by small and large companies alike. To the best of my knowledge, this method of displaying a highly targeted ad is quite possibly the key component to the paradigm shift that is happening right now in the advertising industry. Never before could companies be in front of so many consumers who needed their product or service at that exact instant in time. The old methods of advertising usually had some type of delay built in.

Billions of dollars are being spent on Internet advertising, and the market is growing. It is growing because it is a win-win situation. Consumers who quickly solve their problems win. The company selling the solution to the consumer wins. The Internet company that sold the ad wins. And, finally, a website that displays a syndicated ad wins.

Yahoo! has valuable real estate on their website pages that is seen by tens of millions of people each day. They can sell or lease that virtual real estate to whomever they please or even fill the space with things they create. I do the exact same thing at AsktheBuilder.com, filling my pages with my columns and videos, ads sold by others, and ads I sell myself.

Yahoo! is a public corporation, and it is paramount that they do what is best for their stockholders. If they can lease space on their website to some other company and derive revenue for doing virtually nothing, why would you or anyone stop them? Who is getting harmed? Surely not the people who are clicking the ads! They willingly click them hoping to discover a solution to the problem they have.

Let's take this one more step down the antitrust pathway. When and where will you stop sliding down this slippery slope? I had a discussion with a fellow Internet entrepreneur named Dan Gray. He said, "Tim, are you next? When you become the most visited home improvement website on the Internet, will the Government come in and tell you that you can't display Google ads? If that were to happen, it would be the most un-American thing I could imagine." Dan is right.

If memory serves me right, antitrust actions were initiated when some company or a small group of companies enriched themselves at the expense of others who were harmed financially by the actions of the company or the company. That cannot be said about the proposed deal between Google and Yahoo!. The tens of millions of consumers each day who visit the Yahoo! website are going to see ads that solve their problems. Many will click those ads. Hundreds of thousands of businesses who sell the products and services to these consumers will increase their revenues when those ads are clicked. Those companies end up paying more taxes, and our economy grows.

Who is harmed in this transaction? Perhaps some other company or companies that decided to follow a different pathway in the business jungle. My father-in-law taught me long ago that there is no substitute for brains. Furthermore, I have discovered that healthy competition is a great thing.

This proposed deal has the potential to increase the revenues of Yahoo! by hundreds of millions of dollars each year. The ad revenue that Yahoo! receives from Google will flow into Yahoo! with virtually no expenses. If the management of Yahoo! is wise, they will reinvest this money back into their company to provide the healthy competition that we as consumers want and need. The deal may also force other companies in the Internet business world to work a little harder. My experience as a builder is that a little hard work never really hurt anyone.

Thank you again for taking the time to consider my opinions in this very important issue.

[The prepared statement of Mr. Carter appears as a submission for the record.]

Chairman KOHL. Thanks for your statement, Mr. Carter.

Mr. Crowley?

STATEMENT OF MATTHEW CROWLEY, CHIEF MARKETING OFFICER, YELLOWPAGES.COM., GLENDALE, CALIFORNIA

Mr. CROWLEY. Thank you, Chairman Kohl, Ranking Member Hatch, members of the Subcommittee. I appreciate the opportunity to speak to you today about the important issues raised by the proposed agreement between Google and Yahoo!. I am Chief Marketing Officer for Yellowpages.com—Yellowpages.com is a subsidiary of AT&T. We have an interest in this deal on several fronts.

First off, AT&T is a large purchaser of search engine advertising. We spend millions of dollars a year advertising our products and services through search—, in particular, Google and Yahoo!.

Second, we operate Yellowpages.com which essentially is the Internet extension of the print Yellow Pages. The print Yellow Pages is the means by which consumers and local businesses can connect to each other—Yellowpages.com is essentially that extension.

In addition to the Internet advertising solutions that we provide to small businesses, we also are a one-stop shop for small businesses for digital advertising. We offer several websites—search engine market, we place advertising—agency on Google and Yahoo!, helping them choose their key words and advertise online. So as you can see, we have an interest—our products and services, as well as for tens of thousands of businesses,—places search advertising for them, and particularly today relevant to Google and Yahoo!.

The other meaningful aspect of this deal is that AT&T has had a longstanding business relationship with Yahoo!—Yahoo! continues to remain viable, a viable competitor in this space.

So that being said, we think that we have two issues, concerns with the proposed agreement. One is we do—and the second is—innovation decrease—not just with Yahoo! but across the Net. So I will start with pricing.

Today Yahoo! and Google operate two independent marketplaces for—search advertising. Google is the dominant player in the market with 70 percent. Together, Yahoo! and Google make up 90 percent of the market. Even though Google is the dominant player at 70 percent, Yahoo! is still a formidable alternative for advertisers to place their search engine marketing budget. We can compete and we can compare Google and Yahoo! to each other and select the best price.

Under this proposed agreement, Yahoo! will offer over large portions of its inventory to Google. We expect that the agreement, it has been said, is worth $800 million. It is not insignificant. With Google, we have an opportunity to place advertising. With Yahoo!, we have an opportunity to place advertising. But in this case, inventory on Yahoo! will be diminished. We expect then with a decreased supply of inventory on Yahoo!, prices will go up.

Google is not necessarily an alternative for that because their prices are higher. If you try to buy these ad words, these search terms through Google, Yahoo! is already replacing what they call "lower-value advertising" with higher-value or more expensive advertising through Google, so the price is higher over there.

So as we see it, there is decreased inventory available on Yahoo! and a more expensive channel to purchase our advertising through Google. And Google has been generally more expensive, and even today there was an article that came out in the New York Times blog suggesting that this could increase prices for Google paid ads on Yahoo! by 22 percent.

Our other concern is around Yahoo!'s viability as a business and innovation within the Internet industry in general. So today Yahoo! has all the incentive in the world to compete aggressively with Google to earn its share of the market. Under this proposed agreement, Yahoo! will hand over or cede a significant portion of its advertising to Google and accept what we could call fast money from Google for this ad space. That decreases Yahoo!'s incentive to innovate and compete. It also decreases Yahoo!'s information by no longer processing these advertising transactions by which they can continue to increase their service and increase their offering. So we see that this ultimately increases prices, decreases Yahoo! as a viable competitor, and is not good for the search advertising business and not good for the small businesses that we represent as their agency.

Thank you.

[The prepared statement of Mr. Crowley appears as a submission for the record.]

Chairman KOHL. Thank you, Mr. Crowley.

For you, Mr. Callahan, from Yahoo!, I have this question: Critics of this agreement have argued that Yahoo! is getting paid by its largest rival not to compete as vigorously. In fact, they argue that Yahoo!'s success will now be tied to how well Google performs. Don't your critics have a point, Mr. Callahan?

Mr. CALLAHAN. Mr. Chairman, as we reviewed this agreement and decided to enter into it, the approach for Yahoo! is that we believe we will reinvest the proceeds from this transaction, from the agreement as it goes forward, to invest in our current search business, our search and display advertising business, and indeed continue to vigorously compete with Google. We are not ceding any part of our algorithmic search business, which we built from scratch about 4 years ago, and I think the history of competition on the Internet from our perspective supports that.

From 2000 to 2004, Google supplied all of Yahoo!'s web search, algorithmic search. In 2004, through a series of acquisitions and internal product development, we went from zero in web search to approximately 20 percent to 25 percent, depending on whose data you use.

If you move that history forward the last 4 years, if you will forgive me a prop, in Thursday's Wall Street Journal, "Yahoo! wields new tool to battle Google," and it is our BOSS product, which is an open platform web search initiative to continue our ability and, we believe, fund our ability with this agreement to continue to aggressively compete with Google.

Chairman KOHL. Thank you.

Mr. Smith, from Microsoft, your competitors seem to suggest that this collaboration is just a normal part of doing business. If the agreement is put into practice, what do you think the search advertising business will look like in a year or two?

Mr. SMITH. I think we are going to see a market that is less competitive than exists today. I think that is the reality, and I think virtually all of us in this industry know that is the reality. We have had lots of conversations, certainly in our company and with other companies, even with Yahoo!. On June 8th, we met with Yahoo! in San Jose, and Jerry Yang, the CEO of Yahoo! looked across the table, looked us in the eye, and said, "Look, the market, the search market today is basically a bipolar market." He said, "On one pole there is Google, and on the other pole there are Yahoo! and Microsoft, both competing with Google." He said, "If we do this deal with Google, Yahoo! will become part of Google's pole. And Microsoft," he said, "would not be strong enough in this market to remain a pole of its own."

Mr. Chairman, you asked the question when the hearing started, would this agreement turn Yahoo! into a satellite in Google's orbit? I think everybody knows the answer is yes.

Chairman KOHL. Well, now, that is a pretty strong comment that you just made, Mr. Smith, and, of course, you are under oath and you do recollect quite accurately, I am sure you will state exactly what Mr. Yang said?

Mr. SMITH. I just stated exactly what Mr. Yang said, and it made such a strong impression on us that a few minutes later, when we broke, the four of us from Microsoft walked down the hall to a separate conference room, and we sat down and we said, "I can't believe that Jerry just said those things." And Steve Ballmer turned to me and said, "Think about that. He said, 'There is only going to be one pole in the market.' I guess that would be a mono-pole, wouldn't it?" It made a very strong impression.

Mr. CALLAHAN. Mr. Chairman—

Chairman KOHL. Well, Mr. Callahan, do you have some answers to provide us this morning?

Mr. CALLAHAN. I am sorry to interrupt. I did want to, without addressing Mr. Smith's comments directly, I was a participant in that meeting as well, so I can add to the drama a little bit at the San Jose airport on June 8th. And while I am not going to address Mr. Smith's characterization of Mr. Yang's statement, I will say this: Our board of directors, as part of the evaluation of our strategic alternatives, has made a conscious decision to stay and search, to compete against Google and against Microsoft, and this agreement will enable us to continue to do that. How the market turns in the future will depend upon how successful we are in continuing to compete. And with the initiatives that we have had underway for years and the initiatives that we see in the convergence of search and display advertising going forward—which I think is an important point that I would like to make to the Subcommittee—the current discussion here is about search-based advertising. Yahoo! believes that as the future of this market evolves, advertisers are interested in purchasing a combined search and display.

And if you would forgive me for a moment, I have a prop; I could show sort of what is the difference between the search and display advertisement. But we believe that advertisers look for a combined purchase online. We have a compelling strategy, different than Google, and perhaps different than Microsoft, to build that in the future.

So as you look here, if you will forgive me one moment, this is the current typical Yahoo! search page today, which is—it says "Yahoo!-sponsored search" on the top. And if you could imagine, there is a space here for a banner button, which we call display advertising, which is not search based. Then there is web results, which are from Yahoo!. And here is "Yahoo!-sponsored search," which we show depending upon how the page is put together.

Following implementation of the agreement, this is a possible Yahoo! search page. This would be continued Yahoo! search listings here; continued Yahoo! web search, a product that we built from scratch 4 years ago through acquisition; continued Yahoo!-sponsored search listings here; and perhaps, if we decide to find a better-quality ad than Google, sponsored search listings along here.

Chairman KOHL. Yes, I appreciate what you are saying. Clearly what you are saying contradicts what your boss said. And, you know, that is pretty explosive stuff, and we will have to consider that.

Now we turn to Mr. Hatch.

Senator HATCH. Well, thank you, Mr. Chairman.

Mr. Callahan, in the information that Yahoo! provided the Subcommittee, your company argues that Yahoo! and Google will "compete aggressively against one another in search and display advertising." Now, I have to ask: How can that be? Does not this agreement give advertisers the incentive to bypass Yahoo! entirely and only bid with Google since the agreement creates the strong possibility that an ad will be placed on both Yahoo! and Google's search result pages? Simply put, why bother bidding on Yahoo!'s site when it can go to Google and get two for one?

Mr. CALLAHAN. Thank you for the question, Senator. I believe that advertisers will benefit from this agreement on both the Yahoo! system and on the Google system. As you know, on the Google system they have the opportunity, although not the guarantee, for increased distribution and the reason that is is Yahoo! maintains complete flexibility if and when to source certain ads from Google or backfill certain ads from the Google system. But if an advertiser wants to reach the Yahoo! system—and I think Mr. Carter's testimony about the desire to advertise on both—then they need to go through the Yahoo! system to be guaranteed to reach that. Google will not know when Yahoo! is going to pull certain ads, and Yahoo! is going to do that in a strategic way where we can find a quality ad for us to replace an ad that perhaps for Yahoo! would not be—or does not exist if no one has bid.

Senator HATCH. Let me put it this way: Will Google ads only be in the lower right-hand corner?

Mr. CALLAHAN. No. I am sorry. That was merely an illustration.

Senator HATCH. OK.

Mr. CALLAHAN. The agreement maintains—and it is an important part—Yahoo! complete flexibility to implement this transaction and the way the ads are shown on our site.

Senator HATCH. Mr. Smith, welcome back to the Committee as well, all of you. You have been here before.

Mr. SMITH. Recently, yes.

Senator HATCH. Well, we always enjoy having all of you here.

Microsoft used Overture, which is owned by Yahoo!, to place most of the ads displayed by MSN search engine until 2006. MSN received a portion of the fees for displaying Yahoo!'s ads. Was not that agreement similar to the one being proposed by Yahoo! and Google? And if the Microsoft-Overture contract did not amount to price-fixing, how can you argue now that the Google-Yahoo! agreement amounts to per se price-fixing?

Mr. SMITH. Well, there was—very good question, Senator. But there was one critical difference—

Senator HATCH. It needs to be asked. That is why I am asking it.

Mr. SMITH. There was a critical difference. We were not in the market for search advertising at that time, so we were relying on Yahoo! or, in that case, Overture to provide that service to us. We are now in this market. All three of us are in this market. So any agreement between any of us is in a different category because we are competitors. And if you look at the pages that Mr. Callahan showed, they really drive home this point.

The first page, as he said, is a Yahoo! page today. Actually, if you look at it carefully, it is what displays when somebody types in the word "flowers," and you get a lot of ads from people who sell flowers. And in the second page, the page that will exist in the future, someone types in "flowers," and, in fact, the three ads that he showed being provided by Google, it is the exact same three ads as were there before. It is from the exact same three companies. It is in the exact same place on the Yahoo! search page. The only difference is now those three companies cannot buy their ad from Yahoo!. They have to buy the ad from Google, and they are going to pay more money.

I just think it is inescapable that those three companies are going to pay more money. And because they are direct competitors in the same market, in a way that we were not when we were relying on Overture, it is a very different situation.

Senator HATCH. Thank you.

Let me ask Mr. Carter or Mr. Crowley, won't you be tempted to just use Google? Wouldn't that be more convenient for both of you?

Mr. CARTER. Senator Hatch, that is a great question. I think I can—I first have to say it is kind of interesting to be in this room with these titans of industry, and here I am, I am actually one of their customers, because I buy ads from all three of these gentlemen next to me. And would it surprise you sitting at the dais to know that on either one of their websites right now, when they talk about these expensive ads, what if I told you I can buy ads on their websites right now for pennies a click—not nickels, not dimes, not dollars. Pennies. And every business that is out in America right now can do the same thing.

So I do not want to hear all this belly aching about this is expensive. If you want to buy the big, highly targeted key words, sure, there is a lot of competition for those. But way out on a long tail where a lot of consumers are actually typing these very long key word phrases, you can actually buy ads for very little money.

But to make a long story short, I am not worried about it at all. My business depends entirely upon free search. The way that people come to my AsktheBuilder.com website is through search. I absolutely want Yahoo! and Microsoft to both be viable against Google. The reason that Google is so powerful in search right now is only one reason. I happen to be a previously elected government official. I just resigned about 4 months ago because I got a big project going on. But the reason that you are here today, Senators, is because you were elected to come here. Well, your constituents and all the other consumers in America are voting right now which search engine is solving their problems more quickly. And at this instant in time, it just happens to be Google. Yahoo! or Microsoft or some other two young kids who are in a garage right now might supplant all three of these guys. That is possible. Look at what has happened. Look how quickly we had these giant industries develop. Never in the history of America has that happened, ever. And it can still happen.

So if I were these three gentlemen and their companies and their board of directors, I would be worried each day. But to answer your question, Senator Hatch, I am not worried at all because I am convinced that all three companies are working as hard as they can, maybe some harder than others, and as a result, they are getting more consumers who like the services that they provide.

Mr. CROWLEY. So if I may, if there is time, Senator, I will also respond. As an advertiser, I do have concerns. Today, whether it is pennies or dollars, when you add this up, it is a multi-billion-dollar industry. And if prices go up by 5 percent, 10 percent, 20 percent, those prices are borne by the small and medium businesses that need to carry that freight, by the large businesses that carry that freight. We are the ones that are actually paying for the free Internet. And ultimately that translates into prices that consumers have to pay for goods and services. So it is quite meaningful.

The other thing that is concerning is, as Mr. Carter stated, Google is the dominant play in search today. And by doing this type of deal now, it weakens Yahoo! in terms of their ability to compete. It provides a safety net for them not to innovate. And advertisers like me and advertisers like Crete Truck Sales in Wisconsin or Countertops of Utah in Sandy, Utah, those who come to us to place their search engine advertising will have less choice, higher prices. That is not good for them, and that is not good for the future of this industry. And when I look at the page over there, what I see is not additional choice. Today I can go to Yahoo!. Today I can go to Google. I have that option. I can buy them at competitive rates from two independent marketplaces. In the future, for both AT&T and for our businesses, we would have to pay higher rates to compete for less inventory on Yahoo! and at higher rates in the Google marketplace.

Thank you.

Chairman KOHL. Thank you.

Senator Specter, go ahead.

Senator SPECTER. Thank you, Mr. Chairman.

Mr. Callahan, the arguments made by Mr. Crowley seem to me pretty impressive, especially when backed up with a 90-percent share, which Google and Yahoo! would have. That is a very dominant factor. This hearing has been very both interesting and illuminating, and we are going to have to followup with staffs because we cannot possibly get into all the details here. But it seems hard on the surface to accept the argument that if you have a combination which gives a market share of 90 percent that it is not anticompetitive. We are going to followup because this is something I want to pursue. But give me a 30-second answer to how 90 percent just does not dominate so decisively as to hurt consumers?

Mr. CALLAHAN. Thank you, Senator. The 90-percent figure would be accurate if Yahoo! was exiting the business. Yahoo! is not going to exit this business. We will continue to sell sponsored search advertising, we will continue to be in web search, and we will continue to aggressively compete with Google in all aspects of advertising. There will be no change in how we execute going forward, other than additional resources for us to invest.

Senator SPECTER. You are talking about Yahoo!, what Yahoo! is going to do?

Mr. CALLAHAN. Yes, sir.

Senator SPECTER. But you are representing Google. How do you know what Yahoo! is going to do—oh, vice versa? Well, Mr. Drummond, the question is to you. How will you maintain that kind of vigorous competition?

Mr. DRUMMOND. Apologies. I thought it had been directed to Mr. Callahan. I think he made—that was a very good answer and similar to the one I would have given myself. Again, this agreement gives Yahoo! complete flexibility about what to do. It is not consolidation. There is no merger. We are not—

Senator SPECTER. It has flexibility, but still, if you exercise it, you are 90-percent plus. That is what the consumer has to be concerned with, what your power is.

Mr. DRUMMOND. If they exercise it.

Senator SPECTER. Well, but you have the power to exercise it. Let me move to Mr. Smith for just a minute. Now you have Carl Icahn entering the picture, and Carl Icahn wants Microsoft to acquire Yahoo!. Apparently Yahoo! is worth more money in Microsoft's hands than it is in Yahoo!'s hands, or else they would not want to have a proxy fight about it. That adds another dimension to an already extremely complicated picture. Microsoft is trying to buy Yahoo!, and now you have a collaborator inside of Yahoo! to help you.

What are the machinations of that kind of an acquisition to add complexity to what this Subcommittee already has to consider?

Mr. SMITH. Well, it obviously reflects a fluid situation, Senator, and we appreciate that. There is a proxy contest going forward, and that is governed by the regulations of the Securities—

Senator SPECTER. Never mind fluid. It is Yahoo! is more valuable in Microsoft's hands than Yahoo! is in Yahoo!'s hands.

Mr. SMITH. I do not know that—

Senator SPECTER. Doesn't Carl Icahn think that?

Mr. SMITH. Mr. Icahn has spoken for himself. Let me describe what Microsoft did and the position that we took.

Senator SPECTER. Carl Icahn has spoken for himself, but aren't you working hand in glove?

Mr. SMITH. No. Microsoft made a proposal last week for a search deal with Yahoo!, and we provided that to Yahoo!. It was conveyed to them, and they turned down that proposal.

Senator SPECTER. They turned it down, but if Icahn wins, doesn't Microsoft get Yahoo!?

Mr. SMITH. Not necessarily. I mean, first of all, we have all recognized that, regardless of who wins the proxy contest, no one can guarantee the outcome. There will be a new board. The board will have to do its fiduciary duty. You know, we—

Senator SPECTER. If Icahn wins the proxy fight, you can pretty much tell he will have control of Yahoo!, won't he?

Mr. SMITH. If his slate—

Senator SPECTER. Microsoft will buy Yahoo!.

Mr. SMITH. If the nine directors that he has put forward win, the nine directors will govern the board of Yahoo!.

Senator SPECTER. We may have to have another hearing, Mr. Chairman. I have one question for Mr. Callahan, and I will wrap up immediately. I saw the yellow light.

This is very interesting testimony from Mr. Smith on only one pole if this deal goes through. You were at the meeting. I did not hear you contradict that.

Mr. CALLAHAN. I disagree with how Mr. Smith characterized what Mr. Yang thinks about the market.

Senator SPECTER. Never mind the characterization. What was said?

Mr. CALLAHAN. I don't recall that Mr. Yang said what Mr. Smith had indicated. But I will say this—

Senator SPECTER. You don't recall?

Mr. CALLAHAN. I am sorry—

Senator SPECTER. Does that mean Mr. Smith could be right?

Mr. CALLAHAN. I don't think it would be appropriate for me to comment on Mr. Smith's accuracy or not about how he relayed the conversation.

Senator SPECTER. Well, wait a minute. You were at the meeting. You are a witness.

Mr. CALLAHAN. Yes, sir. It was a long—

Senator SPECTER. What do you say, Mr. Witness?

Mr. CALLAHAN. What I believe is that Yahoo! sees a competitive future with this agreement in place, and—

Senator SPECTER. Was there a comment made about only one pole?

Mr. CALLAHAN. I don't recall that comment, sir.

Senator SPECTER. Are you standing by your testimony, Mr. Smith?

Mr. SMITH. Absolutely. Absolutely.

Senator SPECTER. I have not heard the Chairman talk about the oath being administered, and I have known Senator Kohl since he was elected in 1988. That is pretty tough talk coming from a non-lawyer.

Chairman KOHL. Excellent. Thank you.

[Laughter.]

Chairman KOHL. We are getting into serious business here, folks. We will have to recess for 10 minutes. There is an ongoing vote.

[Recess from 11:35 a.m. to 11:52 a.m.]

Chairman KOHL. We will startup again, and we will ask Senator Hatch to resume his questioning.

Senator HATCH. Well, first of all, this has been an extremely interesting hearing to me, and we never get a real chance to ask all the questions we want to ask. But, Mr. Callahan, how will you decide if it is in Yahoo!'s best interest to place a Google ad on Yahoo!'s search result pages?

Mr. CALLAHAN. What Yahoo! plans to do, once the agreement is through regulatory review, is to implement sending some search terms to Google to backfill ads where Yahoo! does not have the same quality ad that could be returned by Google and one that would have increased relevance, generate a click. And we believe that benefits consumers to the point that Mr. Carter had made, that consumers come to the Internet to look for solutions to problems. That would create a more relevant ad and a better-quality ad. And we think it is good for advertisers as well.

Senator HATCH. Let me ask you and Mr. Drummond this question: Mr. Smith in his written testimony argues that under this agreement, "Yahoo! will never have an incentive to sell an advertisement for less than Google is offering." Specifically, a price floor will be created and that this is per se price-fixing—that has already come up—based under the Supreme Court's decision *United States* v. *Socony-Vacuum*.

I would like you to respond to that argument, because it is an interesting argument and it has been raised by a lot of people.

Mr. CALLAHAN. Yes, I can speak first and then turn to Mr. Drummond.

Senator HATCH. I would be happy to have you—well, both of you should respond, and then I would be happy to have Brad Smith respond.

Mr. CALLAHAN. OK. There is no pricing coordination between the companies as part of this deal. Key word prices—so that price, as Mr. Carter indicated, for cents or whatever it may be—that get bid will be conducted on a separate Yahoo! auction and a separate Google auction. And when Yahoo! has an ad that is drawn from the Google system, that ad will be priced at whatever the price was on the Google system.

Senator HATCH. That sounds good, but as a practical matter, wouldn't it really basically come down to—

Mr. CALLAHAN. I don't think we know that, sir. The bid price for the ad would depend upon whatever the auction is. It would depend on how many advertisers are in that system, what the particular key word is, and then, in fact, whether or not there is a click generated, because advertisers only pay when there is a click. There is no payment from the advertiser is the ad is shown, only if it is clicked, which comes back to our argument why we believe this will, long term, benefit consumers with a more relevant ad in the cases where Yahoo! may decide to draw that ad from Google.

Senator HATCH. OK. Mr. Drummond?

Mr. DRUMMOND. Sure. Let me just add to that. I think there is a fundamental misconception that is being sort of put out here about search monetization, and there is this notion that Google just has high prices and—

Senator HATCH. That is what I have—

Mr. DRUMMOND.—that is the reason—that is the reason why Google is successful. So it is amazing that people could possibly be successful if all we did was take the same old ads that everybody else has and we price them higher. Does anybody think that is a successful business strategy? It is not.

It turns out that what this—this is not, as in the Socony-Vacuum case, a market about a commodity that different purveyors might sell in a spot market. This is a very complicated—it is about as far from a commodity as you can imagine. It is a very complicated—in terms of the outcome, whether an advertiser is going to generate leads and then ultimately sales from an ad is a very complicated process. And it turns out it is very hard to do, and it depends on search traffic, it depends on the types of advertisers, and, most importantly, it depends on the quality of the ad and how good it is. And it turns out when you get it right, when you start figuring out how to do that, what you do is you create more clicks, you create more ads that are relevant, that advertisers want to see. It is the absolute opposite of what was going on in Socony, which was reducing output. It is the opposite. It is increasing output because now you are going to have—because you have done a better job with the targeting, you now have more matches, that is, more consumers are put in touch with advertisers, and that is good for everyone.

So the fundamental misconception here is that the incremental revenue that Yahoo! and Google might make in this deal has to do with just a price increase. What is going on here, as I said in my oral testimony and in my written testimony, what is going on here is that there are more ads being seen, there are more ads being clicked on, there are more relevant ads. And, ultimately, what is important to the advertiser is that they get leads from this and that they get ultimately sales from this.

Now, you could have—you know, the dynamics of each auction are going to be very, very different. There are different players in them. There are different search traffic behind it. And there could be cases where the price ultimately is higher, and Google could be higher on Yahoo!. But what is important to understand ultimately is the value that is being created, so what we have here is an increasing pie that Yahoo! and Google will share in, and that is good. It is more output. It is more supply into the market.

Senator HATCH. Mr. Smith, you can take some time to answer that if you would like, but it just brings to mind if this agreement is non-exclusive and Yahoo! is free to make deals with other companies, does not this undercut your argument that the agreement creates a per se price floor? For instance, Microsoft just purchased Aquantive for $6 billion. Does that not mean that others will be interested in this market and eager to form agreements with Yahoo!? I think it is a relevant question, but you can answer to their comments as well.

Mr. SMITH. First, price-fixing agreements are never exclusive. They all tend to be non-exclusive, and they are usually done with a spirit of "the more, the merrier." That is why the Government takes such a hard line against them. And while lots of things in this industry are complicated, I don't think that the issue that is before this Committee is anything but straightforward.

If this agreement goes into effect, then if Google makes more money, then Yahoo! will make more money. If Google raises prices, Yahoo! is going to earn more revenue. That is not the way the marketplace is supposed to work. And I think Mr. Callahan's own use of his props showed it very clearly. He was showing the exact same ads, not better-quality ads, not new ads that are not existing today, but the exact same ads from the exact same advertisers showing up in exactly the same place. It is just that they go through Google and they cost more money. That is not complicated.

Senator HATCH. Mr. Chairman, could I ask another question?

Chairman KOHL. Go ahead.

Senator HATCH. I don't mean to—

Chairman KOHL. Go ahead.

Senator HATCH. OK. Well, Mr. Drummond, in your testimony you state that Google does not control the prices charged to an advertiser. How can you say that when Google does not determine the winner of its auctions based solely on the amount the advertiser is willing to pay? Do you not take into account "quality scores"? Can you explain what "quality scores" are and how they affect who is declared the winner of your auctions?

Mr. DRUMMOND. Sure. Actually, we are actually quite glad that we pioneered this concept of quality scores in auctions for search, and it has actually been a big part of our success, which has now, I should add, been copied by Yahoo! and Microsoft, who both use them, as well as minimum bids in the auction.

The point of these are to set neutral auction rules that apply to everyone who is in the auction, and think of it this way: Is it a better experience for a—is it a better overall experience to have an advertiser for a camera go in and say, "I will pay $50 for an ad on vacation," when it could well be that that is not a particularly relevant—in other words, when people go on vacation, they want places and so forth, right? So by attaching, by saying it is not just by how much you bid but also the quality of your ad, how relevant it is likely to be—and we have a variety of things that we have done over the years to try to figure out those signals and try to make them better, if you factor that into the auction, it turns out that you get better ads, you have more people clicking on them, and advertisers are then going to come up—going to actually compete with each other, not only just on price but to make sure that the ads are very relevant. That is good for them, and ultimately it generates more value overall and more revenue.

These are neutral rules that apply to the ad auction. They are the same—we have some differences between the companies, but all three companies use these, both of these rules. And we are not behind the scenes manually manipulating them any more than we are manipulating the algorithms that drive our search results. It is an article of faith really at Google that, you know, we build this auction, we build our search results, and we use computers—we really like computers—to make these decisions and to make these calculations and to drive these outcomes.

So we have never done any of this manipulation of quality scores or bid prices to affect the outcomes of auctions, and we never will.

Senator HATCH. Mr. Carter, when you are marketing your own products, do you believe that you have ever been unfairly-well, have you ever unfairly lost a bidding competition because of these so-called quality scores?

Mr. CARTER. Not at all. And, Senator, that is a great question. I would like to explain very quickly exactly how all this works from a layman's standpoint and one who is actually buying the ads from these three gentlemen to my right. Here is what is so amazing about this process.

What happens is I can actually-if I am extremely creative in my ad writing and it is compelling text and it really solves the consumer's problem, I actually may be paying very, very—a much smaller amount for my ad than a competitor that is paying three, four, or five times the amount. He is willing because, remember, it is a free auction. In other words, I am going in and saying—for my crown molding e-book, I may say, "I will pay you 25 cents a click." I may have competitors who say, "I will pay you $1 a click, Google." So here is a competitor who is willing to pay more. But you know what? If my ad is better written and more people click it, say 100 people a day click my ad for 25 cents, Google gets $25 or Yahoo! gets $25, or Microsoft, whatever is collecting the money. But that person who is willing to spend a dollar for a click, four times more than me, and his ad is only clicked, say, five times, Yahoo!, Microsoft, or Google only gets $5.

So they have created technology that recognizes that that is happening dynamically in the auction, and if you were either of these three companies, what would you do? You would force that ad, my ad, which is getting more clicks, higher up in the stack. So these three companies are not controlling the pricing of the auction. It is we as consumers, all of us businesses out there that are buying these ads, we are competing against each other. All that they are doing is matching us up. They are just matching up the people who are coming to search with those of us who create these ads, you know, and those of us who can write the right ad, the really compelling ad.

So, no, I have not been ever treated unfairly. In fact, I wish I could give more money each day to these companies.

Senator HATCH. Well, I have to leave. That is a very unique comment there, is all I can say.

[Laughter.]

Senator HATCH. We love that form of generosity in the Federal Government.

I have got to leave, but, Mr. Smith, do you have anything to add on this, on this quality score issue, or anything else, for that matter?

Mr. SMITH. Well, I think the important thing to focus on here is this is not about Google's overall business, this is not about the model in and of itself for the way auctions take place. That does have an important impact because prices are, in fact, set in what is in truth, I think, a combination of bidding by advertisers and the minimum prices that are set. In fact, our understanding is that Google sets a different minimum price for each advertiser and different quality scores as well.

Those are important, but that is really not the heart of the issue. The heart of the issue is the agreement, and the heart of the issue is whether two competitors that account for this kind of market share should be able to come together and enter into this type of agreement.

Senator HATCH. Well, thank you all. This has been very interesting to me. I want to thank the Chairman for allowing me to go on here. I have a lot of other questions, but these hearings are—you folks are among the most intelligent people who appear before the Judiciary Committee. That may not be saying much, but we still think—

[Laughter.]

Senator HATCH. We always enjoy having you. It is wonderful.

Mr. CARTER. Thank you, Senator.

Mr. SMITH. Thank you.

Chairman KOHL. Thank you very much, Senator Hatch, for your excellent questioning.

Mr. Drummond and Mr. Callahan, as part of this agreement, the parties have agreed to allow the Justice Department a hundred days to review the agreement. Clearly, Justice would not have taken this unusual step unless they believed that there were legitimate questions about this agreement that need to be addressed.

Mr. Drummond and Mr. Callahan, if the Justice Department says it has problems with the agreement, then are you prepared to either abandon or change the agreement? Mr. Drummond?

Mr. DRUMMOND. Well, let me just first say that we actually voluntarily called the Justice Department and kind of gave them the opportunity to look at it. We just felt that although we believe it absolutely is pro-competitive, you know, in terms of all the attention in the space and the size of two companies, it made sense to have them review it. We are cooperating with them on a day-to-day basis, giving them all the information they need and explaining the agreement to them. We are confident that they are going to, once they understand it and go through all of the facts, they will see it the same way. If they have any issues with it, we will work through those issues with them, most certainly.

Chairman KOHL. Mr. Callahan?

Mr. CALLAHAN. Yes, sir, I would echo Mr. Drummond's comment and also add that, given the attention that had been on the Yahoo! situation from the time of Microsoft's unsolicited proposal through this weekend's coordinated—what at least we see as a coordinated approach to Yahoo! between Microsoft and Carl Icahn and the disruption of a proxy fight, the annual meeting that is coming, we did reach out to the Department of Justice, as Mr. Drummond indicated, and I think I would echo his comments that we would look forward to working through any issues.

Chairman KOHL. Mr. Crowley, we have spoken a lot today about the strength of Google in search advertising, yet there are, as we know, other forms of Internet advertising, such as display. Google has a very small share of these types of ads. Doesn't the fact that advertisers do have other ways to advertise on the Internet make it unlikely that this deal will cause ad prices to rise? And if prices were to rise for search ads, as you suggest, wouldn't advertisers just switch to display ads?

Mr. CROWLEY. Thank you for the question. No, we don't believe and I don't believe that display ads are an adequate alternative to search marketing. Display ads are generally brand advertisers. They are generally wrapped around the page. There is a phenomenon called "banner blindness" where Internet users have been trained not to look at the display banners but to look into the search results.

So there is a place for display advertising on the web, no doubt. It is a different type of advertising than sponsored search. And from the small businesses that we sell our advertising solutions to, we do not see that as a viable alternative. There was, in fact, a point in time where we did sell display banner advertising to small businesses, and we got out of that business and replaced it with the search engine marketing solution that we offer today because that is where the demand was and that is where the value was at the time we made that decision.

Chairman KOHL. Mr. Callahan, as we have discussed this morning, Yahoo! estimates that it will eventually earn $800 million more annually with this outsourcing arrangement. According to industry estimates, this is an increase of more than 50 percent from what Yahoo! currently earns. If that is the case, why would Yahoo! ever terminate this arrangement? In fact, if Google does a much better job of making Yahoo! money, will there not be every incentive in the long run for Yahoo! to outsource all of its Internet advertising to Google?

Mr. CALLAHAN. In the analyst conference call around June 12th, we did note that we saw this as a potential revenue opportunity of $800 million on an annual basis, but that we expected in the first year following implementation approximately $250 million to $450 million of operating cash flow. And our incentive under this agreement reflects how the agreement is structured, that we have the option to use the ads where we think it helps on the quality and obviously helps Yahoo! generate this additional cash-flow. Our incentive is to sell as many Yahoo! ads as possible. We keep all of the revenue from those ads. Our incentive as we go forward is to maintain a robust marketplace in search advertising, and that depends upon advertisers like Mr. Carter but also user traffic. And creating user traffic and drawing user traffic is based upon a relevant page, which is the overall relevance that is helped by better-quality ads, and some of those may come from Google.

Chairman KOHL. Well, Mr. Smith, wouldn't you agree with the premise of my question?

Mr. SMITH. I absolutely would agree with the premise of your question, Senator, because to the extent that prices on Google continue to rise, then it is clear that Yahoo! will have every incentive to send more ads to Google.

Now, it is certainly true as well, as Mr. Callahan suggests, that in some cases their prices may already be as high as they are on Google and they will not send those. But where they are lower, every incentive is to send ads. When you put that together, it really does constitute an effective floor on prices. Yahoo!'s prices may never be lower than Google's prices because whenever they are, Google will set the price and Yahoo! will send them the ads.

It is bad news for advertisers.

Mr. CROWLEY. Chairman Kohl, if I may comment on that?

Chairman KOHL. Yes, Mr. Crowley.

Mr. CROWLEY. Mr. Drummond did mention that this is hard, it is complicated, and I think that is the point: that it is difficult, it is not easy to do, and we want to see Yahoo! competing vigorously, fairly in the market to bring their services up to par, to be an adequate alternative to Google. And by renting out their real estate to Google and accepting the money from Google and decreasing that incentive to innovate and compete, we think it is bad for the market and bad for the future.

Chairman KOHL. Mr. Smith, let's be as frank as we can in this hearing this morning. Is it not true that your opposition to this agreement between Yahoo! and Google is highly motivated by the fact that Microsoft wants to acquire Yahoo! yourself? And wouldn't such an acquisition be just as anticompetitive as the deal we are talking about this morning?

Mr. SMITH. A fair question, certainly, Senator, and let me say a few things in response.

First, yes, Microsoft has obviously been strongly interested in coming to some kind of important transaction with Yahoo!. Now, there have been different terms, different forms that have been discussed over the last 6 or 7 months, but we clearly have that interest, and that is unquestionable.

But, second, we would have serious concerns about this agreement regardless of whether there was any possible transaction with Yahoo!, and there may not be a possible transaction with Yahoo!. It has not worked very well so far, as everybody has seen. So independent of whether there is ever an opportunity for Microsoft to do anything with Yahoo!, we do have concerns about this kind of arrangement.

But then, third, it is also a fair question: What would the world look like, what would this market look like, if Yahoo! and Microsoft were to come together in some way around search and search advertising? We believe that would create a more competitive market because this is a very scale-based business. It does require very substantial capital investments. One needs to have a critical mass of market share in order to ensure an ongoing and sustainable level of competition. And if Microsoft and Yahoo! were to team up in some way, you know, we would bring together 20 to 30 percent of the market. We would have a critical mass, and the market would be more competitive.

So our view is that if you put a small number 2 and an even smaller number 3 together to balance this gigantic number 1, that is going to lead to a more competitive balance and more competition that is sustainable.

Mr. DRUMMOND. Senator, do you mind if I just respond to that?

Chairman KOHL. Yes, Mr. Drummond.

Mr. DRUMMOND. Let me just say that there really are two alternative scenarios here, and I guess when you start thinking—you have got to think about which one is better. You have an independent Yahoo! that makes an arrangement with Google that is going to lead to better ads for consumers, so they get better information than they had before because of Google's ad technology. Advertisers are going to get more leads than they had before. The pie of advertiser value grows incremental from what we have today. And Yahoo! actually is able to generate additional—you know, gets a share of that, the lion's share of that, I should say, and reinvests that into the rest of their businesses and stays as an independent competitor in this market.

Or you can have a situation where Yahoo! is gobbled up by Microsoft, eliminating them from the competitive playing field, and Mr. Smith wants you to believe that the only business that our three companies are engaged in is search. Well, it turns out that is Google's primary business, but it turns out also that both Microsoft and Yahoo! have very large display advertising businesses. Yahoo! is number 1. Microsoft is number 2. They have hundreds of millions of e-mail customers between them. They are two of the leading instant messaging companies, and on and on and on.

So this is not about search entirely. It is about the Internet in general. I think there would be significant concerns about a combination of those two companies.

Chairman KOHL. Mr. Carter?

Mr. CARTER. Senator Kohl, I can tell you that from my standpoint as a publisher and as a consumer, I want all three of these companies to survive. I do not want anybody to be gobbled up by anybody because as a buyer of ads and as a business that can actually take that same advertising, please understand, I am currently doing the exact same deal with Google, and I was approached by Yahoo! several years ago to do what we are here talking about today, meaning I display Google ads on AsktheBuilder.com. It took me 5 or 10 minutes to put the code on my website to do that. Then, instead of me out there trying to sell my own ads, I am able to go back and write more columns or write more content or make more videos so that I can have more ads.

So I want all three of these companies to survive and to thrive, and I can tell you that the marketplace is making that happen now. And once again, I will just reiterate, the reason that I feel that Google is so powerful in the search marketing area is because they did such a good job early on in being able to match those ads with the search term that people were searching for. And that is really what the crux of the matter is, in my opinion. And we absolutely want to see Yahoo! improve their search algorithms. I want to see Microsoft work 24 hours a day to improve theirs. And I want to see who the number 4 player is. I don't know who that is. Maybe Dogpile is going to come back to life. Maybe AltaVista is really going to get juiced up again. But the point is there are other search engines that are out there, and I am telling you, history will prove it right, and we may all be dead in this room when it happens. But I am telling you that there will be a company that is going to crush all three of these people.

[Laughter.]

Mr. CARTER. It will happen. They don't want to hear that, but history has shown that to us. And we have got a rich history in this country.

And remember, once again, all I want to add is that if you block this deal, if you go down that pathway, am I going to get a letter from you 1 day? I mean, that is a question I will ask you, because I am on my way to becoming the most popular home improvement website, Yahoo! is the most popular, most visited website right now. So are you going to then say, "Tim, sorry, you cannot do Google ads anymore"? Come on. That is un-American.

Chairman KOHL. OK. Mr. Callahan?

Mr. CALLAHAN. Yes, Mr. Chairman, I thought I should comment. There has been some discussion about Yahoo!'s future, and I thought it would be appropriate for me to say that, consistent with what we have said from the beginning, Microsoft had made an unsolicited proposal and then subsequently withdrew it. They made a joint proposal to acquire a search business and restructure the company with Mr. Icahn over the weekend, and we rejected that. Consistent throughout that process has been Yahoo!'s board's focus on stockholder value, and I would like to reassure Mr. Crowley and Mr. Carter and others that we will continue to innovate with this agreement in place, continue to compete, and continue to build a stronger Yahoo! for the future, however that path may take us.

Mr. CROWLEY. Senator Kohl, if I may? Like Mr. Carter, I agree. I want three viable, four viable, five viable alternatives in the search market. Mr. Carter also stated that it is working today. My concern is that I don't know that there is just two options, as Mr.

Drummond has suggested. I don't know that there are not other alternatives for Yahoo! to get funding or to continue to innovate. And in this situation, we see it as a concern because you have got Yahoo!, who is wanting to innovate, we are wanting to compete, getting out of a large part of their business, ceding it to their largest rival.

If you take a comparison, let's just look at an auto deal. What if the by far No. 2 auto dealer gave up a significant amount of its floor space to the dominant auto dealer in the market, but then said that they were going to use the proceeds from those sales to come back and compete with that same auto dealer? It just—it does not seem to make a whole lot of sense, and I think there are better ways for Yahoo! to compete, and I think there are better ways for us to have a better search marketing ecosystem.

Chairman KOHL. All right. One last question, folks. Generally, bid prices for search advertising are lower on Yahoo! than on Google. If Google's higher prices are now used to sell ads on Yahoo!, does not this deal eliminate the choice for small advertisers who would rather allocate their marketing budget to Yahoo!? Mr. Smith.

Mr. SMITH. Well, that is precisely one of our concerns, and while Mr. Callahan talks about Yahoo! taking the proceeds and reinvesting, the reality is that advertisers who find that their ads are no longer being winnable at Yahoo! are going to have a lot of incentive to just shift their business to Google. And the Yahoo! folks have talked about various ways they would like to avoid that, but I think that result is, in fact, unavoidable the way this agreement has been set up.

The reality is when Google's prices rise, Yahoo! makes more money. That is not the way the number 1 and two players in a market are supposed to interact.

Chairman KOHL. Yes, Mr. Carter?

Mr. CARTER. Senator Kohl, I think the reason for the facts of why those prices are lower is because there are fewer people in that auction at Yahoo!, and with no disrespect to Mr. Smith, the same is happening at Microsoft, meaning when I buy ads on both of those search engines, I can get clicks for less money. But that being said, if I can get—from my standpoint as a businessman, I make more money than when I am buying from Yahoo! and Microsoft. So, in other words, that is why I want all three of them—and just like Mr. Crowley said, I want a fourth and a fifth search engine to come into the marketplace because I want there to be even more competition than there is.

So I can tell you that the marketplace is controlling these prices, and don't forget, sir, that each of these websites—Microsoft, even Google, even Yahoo!—they have other real estate on their pages that they can devote to revenue. And one of the points that Mr. Callahan said earlier is really, really important. Please understand that when a person at Yahoo! clicks a Yahoo! ad, Yahoo! keeps all the money, just like at my website. When I sell ad space of my own, I get all of the revenue. I do not have to split it with Google or anyone else. So that is really, really key here. Remember, you are only talking about a small slice, potentially, of the real estate on these pages. And if Yahoo! discovers that all of a sudden they are making more money by selling these particular ads, they are going to either turn off the Google ads, like I do—I turn off Google ads on my own pages. They probably don't like to hear that, but I get more money from certain advertisers. Too bad. You know, maybe they need to do a better job and get better prices in the auction.

So it is a very dynamic thing, and you have to go very, very slowly here, because you may end up hurting somebody like me 5 years from now, and I will not be real happy about that.

Chairman KOHL. All right. Gentlemen, that will conclude testimony at the hearing. We will leave the record open for a week. I would like to thank all of our witnesses for being here.

Today's hearing demonstrates the importance of this market and that this deal does raise significant competition concerns. So we will continue to examine this transaction closely in the days and weeks ahead. We will also be following the news regarding the possibility of future consolidation in this market and its impact on competition.

We thank you all for being here. The hearing is adjourned.

[Whereupon, at 12:24 p.m., the Subcommittee was adjourned.]

[Questions and answers and submissions for the record follow.]

QUESTIONS AND ANSWERS

Senator Kohl's Follow-Up Questions to Michael Callahan
Hearing on "The Google-Yahoo Agreement and the Future of Internet Advertising"

1. *(a) Mr. Callahan, at the hearing Microsoft General Counsel Brad Smith testified that Yahoo! CEO Jerry Yang told Smith at a meeting on June 8, 2008 that if Yahoo! entered this agreement with Google that "Yahoo! would become part of Google's pole" in a "bipolar search market." You testified that you were present at that meeting, but when both I and Senator Specter asked you if Mr. Yang made this statement you replied that "you didn't recall" whether Mr. Yang made that statement. Now that you've an opportunity to reflect on the meeting and what was said, do you recall whether Mr. Yang made that statement or something similar? Did he say that Yahoo! would become "a part of Google's pole" (or words to that effect) if Yahoo! entered into this agreement with Google?*

As I stated at the hearing last month, I do not recall such a comment. Such a statement would have been inconsistent with the Yahoo! Board's decision to maintain Yahoo! as an innovative, robust competitor in the search advertising space.

Yahoo! believes that the future of online advertising lies with the convergence of display and search. By remaining fully engaged in the search business and accelerating its strategy to provide one stop shopping for advertisers, we believe Yahoo! will be even better positioned to succeed in this evolving market. The financial benefits of this commercial business arrangement will, in part, enhance the resources Yahoo! has to invest in advancing its core strategies and make us a stronger competitor to Google and other companies. Yahoo! is ceding nothing to Google and is not exiting search through this agreement.

(b) In conversations generally, did Mr. Yang ever say anything that sounded like Brad Smith's recollection of the June 8 comments either at that meeting or at any other time? Did he say anything that caused you to believe that Mr. Yang considers that there would only be one strong pole in the internet search market, and Yahoo! would be part of it, as a possible outcome of this deal?

Not that I recall. As stated, any such statement would have been inconsistent with the Yahoo! Board's decision to maintain Yahoo! as an innovative, robust competitor in the search advertising space. Our actions throughout this process make it clear that the decision made by the Yahoo! Board was to improve our competitive position, not cede it.

2. *By its own estimates, Yahoo! will eventually realize as much as $ 800 million more in ad revenue annually with this deal with Google. This windfall must come from somewhere, and we know it won't come from Yahoo! taking business from Google. So we must conclude from that this additional revenue will come from higher advertising rates. How do you respond?*

One of the great benefits of Internet advertising is that advertisers generally do not pay for ad placement – they only pay when a search user actually clicks on an ad. The more clicks an ad generates, the more revenue it generates for the company hosting the ad (Yahoo! or Google, for instance), and at no cost to the consumer. Therefore, more relevant ads translate into higher revenue for all parties and more lead generation for advertisers. Also, keep in mind that, as before, ad prices will continue to be set by fair, open auctions, where advertisers bid in accordance with the value they expect to receive, so competition in this space will remain as robust as always. This agreement allows Yahoo! to supplement its own ad offerings with more relevant advertising from Google. We believe that the additional consumer engagement generated by this additional relevancy will be a boon to advertisers and will ultimately generate a great deal of the additional revenues in this deal.

3. *At the hearing, you argued that advertisers should not worry about price increases because the price of internet search ads is set by "open and fair market-based actions" among advertisers, not by Yahoo or Google. A couple of questions about this:*

First, doesn't Yahoo! set a minimum price for each search term in the auction? Isn't there a risk that this minimum price will increase if Google and Yahoo! no longer compete as vigorously?

Google and Yahoo! will compete as vigorously as always – prices will be set by independent, open auctions. Any minimum prices will be set with regard to relevance and Yahoo!'s own marketplace.

Second, isn't it true that the highest winner in the auction doesn't always win? You determine the winner by looking at other factors, such as whether the bidder is a strong advertiser which consumers are likely to click on, right?

It is certainly true that relevance to our users plays a key role in where advertising is placed on our site and, in some cases, who "wins" the right to have key placement. It does no good to our advertisers or our users (or to Yahoo! itself) to have irrelevant ads that receive no clicks. Because an advertiser pays nothing unless the ad is clicked on by a viewer, it sometimes makes no sense to have a high priced, completely irrelevant advertisement in a key area. This process is not designed to simply increase revenue to Yahoo! – it is designed to help advertisers and users with increased relevance and thus generate more click-throughs and more conversions.

4. (a) In response to my question at the hearing about what Yahoo! would do if the Justice Department recommended against the Yahoo!-Google deal, you said that you would "work through any issues." But this does not answer my question, so let me restate it. If the Justice Department opposed this deal as anti-competitive, would Yahoo! terminate it or would you go through with it anyway, forcing the Justice Department to bring, and win, an antitrust suit in court in order to block it?

While we believe we would win any action taken against this agreement, we do not believe it would ever come to that. We have kept the Department of Justice informed and are cooperating fully, and we are confident that the Justice Department will agree with us that this agreement is not anti-competitive.

(b) Would Yahoo! agree to make monthly or quarterly reports to the Justice Department regarding the competitive consequences of the deal – including how much revenue Yahoo realizes under this arrangement; the number of advertisers that have left or joined Yahoo's network; whether this has led to increases in minimum ad prices – should the Justice Department request such reports after its review of the deal?

Yahoo! has been having discussions with the Department of Justice about this agreement for some time, and will continue to discuss whatever concerns or suggestions they have.

5. Yahoo! has stated that eventually it will realize $800 million more annually from the deal with Google. It is fair to say that as Yahoo! earns more for the advertisements that it places, Google will likewise make more money. If Yahoo! chooses to be an independent company again at some point, as it has stated, at that point Yahoo! will have to forego the extra revenue made as a result of Google's success. It seems doubtful that at some point you will be willing to tell your shareholders that you are going to choose to make less money. Can you comment?

First, nothing in this agreement changes Yahoo!'s status as a strong, independent company. Yahoo! remains committed to the search business, and one purpose of this agreement is to help Yahoo! compete successfully in the converged search and display online advertising space. We have invested millions in improving our technology and functionality in online advertising and, and we intend to remain a formidable competitor and a significant principal in paid search. Over time, as Yahoo! strengthens its competitive presence, we have every intention of generating more revenue from Yahoo!'s own ads. We have every incentive over time to minimize the use of Google's system to advance our own strategic objectives. Meanwhile, Yahoo! has already told its shareholders that it has chosen, through a measured and thoughtful implementation of the Services Agreement, to make less money than it could through a complete outsourcing of sponsored search ads. The reason is simple: in the long run, strengthening Yahoo!'s advertising initiatives will make Yahoo! a stronger competitor.

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6. We understand that under this agreement the amount of advertising outsourced is at Yahoo!'s discretion. We can all agree that if almost none is outsourced that we have fewer competition concerns than if most or all of it is.

What is the correct way to analyze this transaction under the antitrust laws? Given that the amount of advertising outsourced is at Yahoo!'s discretion, should we presume in the analysis that Yahoo! does, in fact, outsource all of its advertising as it could do under the agreement?

It would make no sense to speculate that Yahoo! would outsource all of its advertising, since that is contrary to our announced intentions. The correct framework is to view the Services Agreement as a vertical agreement in which Yahoo! as a publisher will call upon Google for ads that supplement Yahoo!'s own sponsored search. Prices will be set by independent auctions, and we have every intention to increase our share of online advertising over time.

7. The Federal Trade Commission analyzed the most recent transaction in this sector – when Google purchased DoubleClick. Given the FTC's background and understanding of the market, is there a reason that you gave the review to the Justice Department and not to the FTC? Do you think that the FTC should also review the agreement?

It is our understanding that the Department of Justice and the FTC mutually allocated this responsibility to the Antitrust Division of the Department of Justice, and this is why we have been in discussions with the Department.

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August 12, 2008

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Washington, DC 20510

RE: Follow-up Questions for Matthew Crowley

Dear Senator Kohl:

Enclosed is AT&T's response to your follow up questions directed to Matthew Crowley regarding the hearing entitled "The Google-Yahoo Agreement and the Future of Internet Advertising", conducted on July 15, 2007.

Sincerely,

Bruce R. Byrd

Enclosures

Response of AT&T to Follow-up Questions from Senator Kohl
"The Google-Yahoo Agreement and the Future of Internet Advertising"

Q. The price of internet search advertising is set by an auction among advertisers for search terms, isn't it? So why do you worry that this agreement between Yahoo and Google will raise ad prices?

A. Google and Yahoo! do sell search advertising through processes that employ certain auction *features*, but those processes are by no means true auctions in which there are transparent, public sales to the highest bidder by a neutral "auctioneer." That is, while the Google and Yahoo! auctions involve the acceptance of bids from advertisers that want their ads featured on search results pages when particular search keywords are used, Google and Yahoo!, not the advertisers, retain ultimate discretion over search ad prices through their complete control over, among other things, the minimum bid reserve prices, the black-box ad "quality" rankings, and the number of advertising "slots" they choose to make available for a keyword search.

The ability of Google and Yahoo! to raise prices in the "auctions" they conduct is relatively simple to illustrate. First, either one can simply reduce the number of ad slots it makes available. If, for example, Google offers five ad slots for a popular keyword (*i.e.*, one that is highly relevant to many advertisers' products), an advertiser must achieve a top-5 ranking in a Google auction for that keyword in order have its ad shown. All else being equal, if Google reduces the number of ad slots to 3, prices are likely to rise, as the same pool of advertisers competes for fewer slots. Google's dominant share of the search advertising business already gives it the incentive and ability to employ this strategy to some extent today,[1] and it would be even more inclined to do so if Yahoo! is allowed to cede a significant portion of *its* ad slot capacity to Google, reducing the competitive threat of Yahoo! as an alternative supplier.

Second, both can raise prices even if neither chooses to reduce the number of available ad slots. Google establishes a "minimum per click" reserve price for each keyword, which represents the lowest amount an advertiser may bid to be considered eligible for delivery with the search results when a search includes that keyword. Google can even set different reserve prices for each advertiser based upon experience with that advertiser's bidding practices. Simply by raising the undisclosed reserve prices that are entirely within its control, Google can raise the prices that bidders that qualify for one of the available ad slots must pay. Indeed, a recent paper published by Google research employees recognizes that "enforcing minimum prices can improve revenue" and that "bidder-specific minimum prices" are "not innocent."[2] Yahoo! similarly sets minimum bid prices in its "auction."

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1 Saul Hansell, "*Google Deliberately Sells Fewer Ads — and May Have Gone Too Far,*" N.Y.Times blog, July 17, 2008, *available at* http://bits.blogs.nytimes.com/2008/07/17/ google-deliberately-sells-fewer-ads-and-may-have-gone-too-far/index.html?ref=technology.

2 *See* Even-Dar, Feldman, Mansour, and Muthukrishnan, *Position Auctions with Bidder-Specific Minimum Prices*, available at http://research.yahoo.com/workshops/ad-auctions-2008/schlpapers.html.

Finally, Google and Yahoo! select the ads that will appear with search results, not simply by ranking advertiser bids per click from highest to lowest, but by combining those bids with their own proprietary ad and advertiser "quality" scores, which are also entirely within their control. That is, after contending with shifting minimum prices and the ad networks' full control over the number of ad slots, advertisers then are subject to the particularly non-transparent quality scores that are the final arbiters of whether an ad appears and, if so, in which ad slot. In short, there should be no mistake that Google and Yahoo!, not advertisers, set prices for search advertising on their respective ad platforms.

To be clear, none of this suggests that these pseudo-auctions necessarily are illegal or improper. Rather, the pressing issue worthy of the committee's attention is that, today, competition from an independent Yahoo! is a significant check on Google's incentive to exercise its discretion to raise prices through the various means available to it – *i.e.*, Google understands that advertisers could and would shift more of their business to Yahoo!-supplied ad slots in response to a Google price increase. But under the proposed agreement between these competitors, Yahoo! would turn over many of its ad slots to Google, seriously weakening Yahoo!'s vitally important role as a competitive constraint on Google's pricing practices.

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August 12, 2008

Senator Herb Kohl
Senate Judiciary Committee
Subcommittee on Antitrust,
Competition Policy and Consumer
Rights
SH 308
Washington, DC 20510

Re: July 28, 2008 Letter with follow-up questions to the July 15th hearing on "The Google-Yahoo Agreement and the Future of Internet Advertising"

Dear Senator Kohl:

I appreciated the opportunity to speak with you and your Subcommittee at the July 15, 2008 hearing and am writing to respond to the follow-up questions posed in your letter dated July 28, 2008.

Before turning to the follow-up questions, I would like to clarify an incorrect assertion made by Microsoft at the hearing. Microsoft suggested that Google's nonexclusive advertising services agreement with Yahoo! would give Google a 90% share of a relevant market. This claim is incorrect. In fact, Google has less than a 30% share of the online advertising market and will continue to have less than 30% after this agreement is implemented.

First, the relevant market in this matter is not limited, as Microsoft now suggests, to a narrow category of search-targeted text advertisements purchased from web search providers such as Google, Yahoo!, Microsoft, and Ask. The relevant market includes, at a minimum, all online advertisements.[1] Google and other web search companies face vigorous competition from online ads that employ other targeting technologies, such as contextual and behavioral targeting, as well as from other online ad formats, such as display ads. Before Google and Yahoo! announced their nonexclusive commercial arrangement, Microsoft agreed with this point.

[1] For purposes of this letter, I limit my discussion to online ads but note that newspapers and other off-line advertisements increasingly compete with Google, Yahoo!, and Microsoft, as Microsoft has previously acknowledged. *See, e.g.*, Don Dodge, Director of Business Development of Microsoft, *Web Advertising Gone Wild*, Don Dodge on the Next Big Thing, Apr. 30, 2007, http://dondodge.typepad.com/the_next_big_thing/2007/04/web_advertising.html ("Google proved there was billions of dollars in small text ads from millions of small businesses. Something the newspapers already knew. And it is newspapers that are feeling the pain of Google's success.").

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Google

For example, in connection with Google's acquisition of DoubleClick, Microsoft made submissions to the Federal Trade Commission asserting that the relevant market includes both text and display ads.[2] Microsoft's General Counsel, Brad Smith, confirmed this point in an interview with Fortune Magazine last year. When asked whether text ads compete with display ads, Mr. Smith explained: "Are they in the same market? It's a very objective question. If the price of one goes up, will publishers switch to the other? We think the answer's yes."[3] Microsoft repeated this claim in testimony before your Subcommittee, asserting that DoubleClick, a display ad serving company, was Google's "single largest competitor."[4]

AT&T has also apparently changed its public position on the relevant market. In a submission to authorities opposing the Google-DoubleClick transaction, for example, AT&T said that text and display ads are relatively close substitutes and that advertisers switch between these alternatives based on price and performance. This is inconsistent with what AT&T told the Subcommittee at the July 15th hearing.

Microsoft and AT&T even jointly funded research by two professors who conducted a study of advertiser behavior and concluded that the relevant market includes both text and display ads. In their published report, Professors Hahn and Singer stated: "the data show that a large percentage of search and contextual advertising customers would substitute to graphic [display] ads in response to a relative change in prices, indicating that consumers perceive those alternative online advertising channels to be substitutes."[5]

We are of course aware of the brief passage in the FTC's closing statement from the DoubleClick transaction suggesting that search ads on web search sites do not often compete with other forms of online ads. We respectfully disagree. This issue was not particularly relevant to the FTC's review of that transaction as DoubleClick does not sell ads of any kind, so the FTC did not engage in a dialogue with Google or DoubleClick about this question. Nor, to our knowledge, did the FTC conduct any economic study to examine the issue or cite such work

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2 *See, e.g.*, Louise Story, Microsoft's Arguments Against Google-DoubleClick Marriage, N.Y. Times Bits Blog, December 21, 2007 http://bits.blogs.nytimes.com/2007/12/21/microsofts-arguments-against-google-doubleclick-marriage.

3 Bradford Smith, Senior Vice President, General Counsel & Corporate Secretary, Legal & Corporate Affairs of Microsoft, *quoted in* Roger Parloff, *On Google-DoubleClick: An Interview with Microsoft GC Brad Smith*, Fortune Legal Pad, Apr. 26, 2007, http://legalpad.blogs.fortune.com/2007/04/26/on-google-doubleclick-an-interview-with-microsoft-gc-brad-smith/. Microsoft's most recent annual report also reflects a view by Microsoft that it competes broadly in online advertising. *See* Microsoft Corp., Annual Report (Form 10-K), at 9 (Aug. 3, 2007), *available at* http://sec.gov/Archives/edgar/data/789019/000119312507170817/d10k.htm.

4 Hearing before the Senate Judiciary Comm. Subcommittee on Antitrust, Competition Policy, and Consumer Rights (Sept. 27, 2007), Transcript of Oral Remarks of Bradford L. Smith, Senior Vice President, General Counsel & Corporate Secretary, Legal & Corporate Affairs of Microsoft at 9.

5 *See* Robert W. Hahn & Hal J. Singer, *An Antitrust Analysis of Google's Proposed Acquisition of DoubleClick 24* (AEI-Brookings Joint Center Related Publication, No. 07-24 Feb. 2008), at 37 and note ††, *available at* http://www.brookings.edu/~/media/Files/rc/papers/2007/09useconomics_hahn.pdf, (thanking AT&T and Microsoft for providing support for the paper).

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in its statement. In contrast, the European Commission analyzed the market definition issue in depth, and in its lengthy and detailed published opinion declined to find that search-targeted ads constitute a separate relevant market. Finally, in addition to being at odds with the views of major companies like Microsoft and AT&T and with the EC decision, we note that the FTC's passing statement on this issue conflicts with at least one U.S. court case.[6]

Both Microsoft and AT&T have acknowledged previously that text ads compete vigorously with display ads. In this more relevant online advertising space, Google's share of revenue is less than 30%.

Second, I would like to address another serious flaw in Microsoft's "90%" claim. Even focusing on just search-targeted text ads sold by web search companies,[7] following implementation of the nonexclusive agreement with Google, Yahoo! will still control the entirety of its search ad business. Yahoo! will make the competitive decisions regarding its own ad inventory, including how many ads to show, where to show them, and which ones (if any) to match through Google's technology. Yahoo! has indicated that it will continue to run its own ad auction and use its own ad matching technology for many of its own ads. Moreover, to the extent that Yahoo! turns to Google for ads, Yahoo! will retain the majority of the revenue generated by those ads; thus, Yahoo!'s share of revenue will actually grow relative to Google's.

Finally, Microsoft's "90%" sound bite is also misleading because even if one focuses on this narrow segment of the online ad market, and even if one incorrectly attributes all of Yahoo's current share within that segment to Google, Google still would not have any market power or "control." To suggest that Google faces no competitive pressure in the sale of search-targeted text ads ignores not only Yahoo!, Microsoft and Ask (not to mention competitors offering other ad formats and targeting technologies), it also ignores several other important sources of existing and potential competition. For example, eBay offers online sellers the ability to list and advertise their products in response to specific searches, and there are over 100 million users who search for product information on eBay.[8] Similarly, Amazon offers online sellers an opportunity to list and advertise their products in response to product searches conducted by its tens of millions of users. These ads are priced on a per-click basis and sold through an online system that is similar to Google's. An example of powerful potential competition is Wikipedia, a web site that tens of millions of users use to search for information which could easily offer

[6] *See KinderStart.com v. Google*, 2007 WL 831806 (N.D. Cal.) ("[T]here is no logical basis for distinguishing the Search Ad Market from the larger market for Internet advertising").

[7] Microsoft explains its "90%" number by asserting that Google has a 70% share of search-targeted text ads sold by web search engines and Yahoo! has 20%. But, even looking at the narrowest possible segment these numbers are questionable. For example, Nielsen.netRatings reports that Google has 59% of web search, Yahoo has 16.6%, and Microsoft has 14%. *See* Press Release, Nielsen Online, Nielson Online Announces June U.S. Search Share Rankings (July 18, 2008), *available at* http://www.nielsen-netratings.com/pr/pr_080718.pdf.

[8] eBay's 2007 annual report also notes that the company is deriving an increasing portion of its revenues from advertising. eBay Inc., Annual Report (Form10-K), at 22 (Feb. 29, 2008), *available at* http://sec.gov/Archives/edgar/data/1065088/000095013408003741/f36571e10vk.htm.

search advertising. As Microsoft's own executive has explained, "Online advertising is exploding, it's kind of a white hot space."[9]

1. Supporters of the Google-Yahoo! agreement argue that advertisers should not worry about price increases because the price of one of your internet search ads is set by an auction among advertisers, not by Yahoo or Google. Michael Callahan of Yahoo!, for example, stated that "prices for search terms are set by open and fair market-based auctions." A couple of questions about this:

First, doesn't Google set a minimum price for each search term in the auction? Isn't there a risk that this minimum price will increase if Google and Yahoo! no longer compete?

Google and Yahoo! will continue to compete after the agreement is implemented. The agreement is simply a commercial arrangement between Yahoo! as a publisher and Google as a supplier of ads, under which Yahoo! will have the option of using Google's strong ad matching technology to supply ads for a portion of Yahoo!'s inventory. The agreement will have no effect on minimum bids in Google's auction. Google's auction determines minimum bids based on a particular advertiser's Quality Score for a specific keyword/ad combination.[10]

Minimum bids in Google's auction help ensure ad quality, and they also help advertisers understand whether their bids are "in the ballpark." Minimums have very little effect on revenue -- in fact, before Google changed its policy a few years ago to allow the minimums to go lower for high quality ads (and higher for low quality ads), Google's minimum bid was 5 cents. In contrast, until just a few months ago, Yahoo!'s minimum was 10 cents across the board. This difference simply underscores that Google's minimums are about quality and transparency, not about Yahoo!, and there is no reason for Google to change this now.

Second, isn't it true that the highest bidder in the auction doesn't always win? You determine the winner by looking at other factors, such as whether the bidder is a strong advertiser which consumers are likely to click on, right?

Google's technology determines the winner of an auction based on a combination of the advertiser's bid and the relevance of the advertiser's ad to the user's search query. Microsoft and Yahoo!'s auctions both use similar approaches – in fact, this is simply a matter of good sense. For example, in announcing its introduction of a quality score metric in 2007 Microsoft explained, "we improved how we establish the quality and relevance of ads and landing pages in

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9 Yusuf Mehdi, Senior Vice President, Strategic Partnerships of Microsoft, Remarks at Goldman Sachs Internet Conference (May 23, 2007), *available at* http://www.microsoft.com/msft/download/transcripts/fy07/YusufMehdi0523207.docx.

10 Google AdWords Learning Center, Lessons Catalog, http://www.google.com/adwords/learningcenter/text/18719.html. *See also* Google AdWords Help Center, What is 'Quality Score' and How is it Calculated?, http://adwords.google.com/support/bin/answer.py?hl=en&answer=10215.

Google Inc. Senator Herb Kohl
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relation to the search user's likely intent. This improvement will ensure that we maintain a high quality of ads and relevance to the Live Search user and is not a radical change, but an enhancement to our existing guidelines around relevance and quality."[11]

Bidding a high price per click is meaningless standing alone when ads are priced on a per click basis – if an advertiser bids a high price but no one will click on his ad, he is not the most relevant ad to users. To take a simple example, suppose FTD bids 5 cents per click for the keyword "flowers" so that it can advertise nationwide flower delivery. If the Milwaukee Flower Shop with only local Milwaukee delivery bids 10 cents per click for the keyword "flowers", users will benefit more if the top slot goes to FTD, even though the Milwaukee shop bid twice as much, as more users will find the FTD ad useful and click on it, generating more revenue.

Taking quality into consideration is therefore useful on many different levels. It means that FTD can bid less to win the top slot. As for the Milwaukee Flower Shop, it might want to bid on a different term, for example "Flowers Milwaukee" – users who click on its ad after typing in those words are much more likely to live in Milwaukee and buy flowers from that store, meaning that each click that the shop pays for will generate more sales for the store. Put another way, the Milwaukee Flower Shop does not want to pay for lots of clicks from users in other parts of the country who will never actually buy flowers from the shop. Taking quality into consideration is good for everyone: FTD wins the top slot for less, users see more relevant ads, and the Milwaukee flower shop can refine its targeting approach and get more for its advertising dollars through smarter strategies.

Google's "AdWords Help Center" provides a detailed tutorial about how Google's system works. As the Help Center explains, when a user enters a search query, Google's sophisticated ad matching technology compiles a list of all ads that it determines to match that query. The list of ads is then ordered based on their Ad Rank.[12] The ad with the highest Ad Rank appears in the most prominent position, the second highest ranked ad appears in the second most prominent position, and so on down the page. On search results pages, the Ad Rank is defined by the Quality Score of the keyword/ad combination and the cost-per-click bid,[13] with Quality Score being derived from the ad's click-through rate on Google, the relevance of the keyword and ad to the search query, and other relevance factors.

2. In response to my question at the hearing about what Google would do if the Justice Department recommended against the Yahoo!-Google deal, you said that you would "work through" any issues that the Justice Department has with the deal. But this does

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11 Microsoft AdCenter Blog, http://adcenterblog.spaces.live.com/Blog/cns!85E824269AB8C30D!352.entry.

12 Google AdWords Help Center, *How is my keyword's Quality Score used?*, http://adwords.google.com/support/bin/answer.py?answer=49174&query=quality+score&topic=&type=f&%20onclick=.

13 Google AdWords Help Center, *How is my keyword's Quality Score used?*, http://adwords.google.com/support/bin/answer.py?answer=49174&query=quality+score&topic=&type=f&%20onclick=.

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not answer my question, so let me restate it. If the Justice Department opposed this deal as anti-competitive, would Google terminate it or would you go through with it anyway, forcing the Justice Department to bring, and win, an antitrust suit in court in order to block it?

We believe that the Department of Justice will and should agree that this agreement is pro-competitive. We have cooperated with the Department in its investigation and have agreed to delay implementation of the agreement in order to give the Department the opportunity to review it (a step not required under federal law). Google is in regular contact with the Department and anticipates that it will continue to have a constructive dialogue with the Department. We cannot predict at this stage every possible scenario if the Department ultimately objects to some aspect of the agreement.

3. We understand that under this agreement the amount of advertising outsourced is at Yahoo!'s discretion. We can all agree that if almost none is outsourced that we have fewer competition concerns than if most or all of it is.

What is the correct way to analyze this transaction under the antitrust laws? Given that the amount of advertising outsourced is at Yahoo!'s discretion, should we presume in the analysis that Yahoo! does, in fact, outsource all of its advertising?

Yahoo! has stated publicly that it plans to use Google's strong ad matching technology for only a portion of its inventory. Indeed, Yahoo! has every incentive not to backfill all of its ads using Google's technology. Yahoo! earns 100% of the revenue generated from every ad it provides itself, but it must share with Google a portion of the revenue generated from any ad Google provides. Yahoo! has repeatedly and publicly expressed its intention to continue innovating and competing in search advertising, a business it believes to be crucial to its corporate mission. And, adding to Yahoo!'s incentive, given that this agreement only involves North America, Yahoo! will continue to supply ads outside of North America in the same manner in which it does today.

The way to analyze the transaction is as a non-exclusive arrangement under which Yahoo! retains control over its own inventory. Therefore, the agreement should not be viewed as combining shares of the companies, who will continue to innovate and compete in the highly competitive online advertising space.

4. The Federal Trade Commission analyzed the most recent transaction in this sector – when Google purchased DoubleClick. Given the FTC's background and understanding of the market, is there a reason that you gave the review to the Justice Department and not to the FTC? Do you think that the FTC should also review the agreement?

The agencies, not the parties, select the reviewing agency. Google played no role in the selection of the Department of Justice and was informed of the decision by the Department.

* * *

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August 12, 2008
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I hope this information is helpful, and stand ready to answer any further questions you or the Subcommittee might have.

Sincerely,

David Drummond
Senior Vice President, Corporate Development and
Chief Legal Officer, Google

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August 12, 2008

The Honorable Herb Kohl
Chairman, Subcommittee on Antitrust, Competition Policy and Consumer Rights
Committee on the Judiciary
United States Senate
308 Hart Senate Office Building
Washington, DC 20510

Dear Chairman Kohl:

Attached please find Brad Smith's written responses to your follow-up questions for the hearing on "The Google-Yahoo Agreement and the Future of Internet Advertising" on July 15, 2008.

Thank you again for inviting Microsoft to testify on these important issues. Please do not hesitate to contact me if I can be of further assistance.

Sincerely,

Jack Krumholtz /VB

Jack Krumholtz
Managing Director, Federal Government Affairs
Associate General Counsel

Enclosure

Senator Kohl's Follow-Up Questions for Hearing on
"The Google-Yahoo Agreement and the Future of Internet Advertising"

For Brad Smith

1. *Proponents of the Yahoo-Google deal argue that we should not be worried about its effect on competition because it only deals with search advertising. But there are other forms of internet advertising, such as display advertising – the banner ads on web pages. Google has a very small market share of these types of ads. Doesn't the fact that advertisers have other ways to advertise on the Internet make it unlikely that this deal will cause ad prices to rise? If prices were to rise for search ads as you suggest would advertisers just switch to display ads?*

This argument is a bit like suggesting that Congress shouldn't worry about the high price of oil because there is still a lot of coal in the ground. While there undoubtedly is, it is of little relevance to someone backing their car out of the garage. In the same way, paid search advertising is a distinct and enormously important economic market, and other forms of online advertising do not substitute for it.

This issue was considered at length last year by the Federal Trade Commission ("FTC") when it considered Google's purchase of DoubleClick. The FTC applied longstanding DOJ/FTC guidelines, which define a "relevant market" to include all products that are in effect *substitutes* for one another in the face of a significant increase in price in one of the products.[1] The FTC determined that paid search advertising was a separate market because of its unique characteristics that separate it from other forms of advertising[2] (*i.e.*, advertisers will not switch to display advertising if the price of search advertising increased 10 percent, at least not in sufficient numbers to make the price increase profitable). Equally important, the FTC found that Google already dominates the search advertising market.[3] The FTC reached this conclusion after reviewing Google's internal documents and speaking with hundreds of industry participants; this is much the same universe of information that will be considered by the Department of Justice.

Moreover, advertisers view paid search advertising as unique from other forms of advertising, because it happens in real time and based upon the consumer's expression of intent. Unlike other advertising situations, the consumer is actively "searching for" information about a product or service as opposed to being "cold called" by an

[1] The FTC reached its conclusions in its review of Google/DoubleClick by applying the Guidelines and well-established legal precedent. *See United States Department of Justice and Federal Trade Commission Horizontal Merger Guidelines*, revised April 8, 1997, *available at* http://www.usdoj.gov/atr/public/guidelines/hmg.htm.

[2] *Statement of the Federal Trade Commission Concerning Google/DoubleClick* at 3, FTC File No. 071-01700, dated December 20, 2007, *available at http://www.ftc.gov/os/caselist/0710170/071220statement.pdf* ("... the evidence shows that the sale of search advertising does not operate as a significant constraint on the prices or quality of other online advertising sold directly or indirectly by publishers or vice versa.").

[3] *Id.* ("Google, through its AdWords business, is the dominant provider of sponsored search advertising ... .")

unsolicited ad. In that sense, paid search and display are very different (in antitrust parlance they are *complements* not substitutes), with advertisers using display to *create* demand and search being used to *fulfill* it.

The FTC's decision in Google/DoubleClick and the principles governing market definition generally also establish that contextual advertising is not in the same market as paid search but instead should be viewed as a *non-search* product.[4] Even if the paid search market included contextual advertising, the agreement still violates the antitrust laws because it reduces the competitive constraint of Google's closest competitor in the search *and* contextual advertising where Google and Yahoo! are the number one and two players.

2. *A decade ago, Microsoft held a dominant share of the personal computer operating system market (indeed, higher than Google's share of the search advertising business today) and faced an antitrust suit from the Justice Department. It defended itself by claiming it should have the "freedom to innovate." Don't Google and Yahoo! have the "freedom to innovate" in their Internet search advertising business, and why isn't this deal an example of the "freedom to innovate" that your company once so strongly championed?*

A decade ago Microsoft expressed concerns about potential legal restrictions on the ability of a single firm to improve its products by adding new features. In contrast, the agreement between Google and Yahoo does not provide any new search features for customers. All it does is add a mechanism that will enable Yahoo! to impose a price increase.

Both Google and Yahoo! already offer paid search advertising today. In the past they have innovated in competition with one another and should continue to do so. What makes the present agreement so noteworthy is that it entails direct competitors colluding, rather than competing, and doing so with respect to price, not product features. Antitrust policy has long been especially skeptical of agreements between direct competitors, especially those that lead to increases in consumer prices. Yet that is precisely what will result if the agreement between Google and Yahoo! takes effect. Indeed, this opportunity to raise prices is the reason the agreement was put together in the first place.

Indeed, Google and Yahoo! do not deny and in fact have stressed that there will be no operational integration between the companies. They are not going to jointly develop or create any new or innovative products. While the integration from mergers and joint ventures can lead to innovation, the creation of new products, and cost savings, straight agreements between competitors like this one do not create any of these benefits. In the absence any such benefits, the Google and Yahoo! are left with little more than a bare marketing and pricing agreement between head-to-head competitors that together control 90 percent of the marketplace.

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[4] *Id.* at 5-6 ("We therefore determined that contextually targeted ads do not constitute a separate [non-search] market; rather they are part of a broad market that includes all ads sold by intermediaries.")

While Microsoft's arguments from a decade ago obviously generated their own debate, this new agreement is far afield from these issues. And while Microsoft definitely acknowledges that Google and Yahoo! have each innovated in the past and separately from each other, they should not be permitted to entrench their position through collusive agreements or other artificial means that undermine competition and hurt consumers.

SUBMISSIONS FOR THE RECORD

Opening Statement of Michael J. Callahan
Executive Vice President and General Counsel of Yahoo! Inc.
Hearing Before the Senate Judiciary Committee
Subcommittee on Antitrust, Competition Policy and Consumer Rights
July 15th, 2008

Thank you Chairman Kohl, Ranking Member Hatch, and members of the subcommittee. My name is Michael Callahan, and I am Executive Vice President and General Counsel of Yahoo! Inc. I appreciate the opportunity to be here today to discuss the dynamic and growing Internet advertising space and the commercial agreement between Google and Yahoo!.

Yahoo! welcomes this hearing and we are confident that the more one learns about this agreement, the more clear it becomes that it is good for competition – good for consumers, good for advertisers, and yes, good for Yahoo!.

The purpose of this commercial arrangement, and the intent of Yahoo! moving forward, is to help make our company an even stronger competitor to Google, to Microsoft and to others in the dynamic and rapidly growing online advertising world.

As I am sure you know, this has been an interesting time for our company, to say the least.

While I don't want to dwell on the very public proxy fight in which we are currently engaged, I want to spend a brief moment on it because it will give you a flavor for how intensely competitive the search business has become. All of the companies at this table are laser focused on being significant players in search. With this business arrangement, Yahoo! will continue to execute on its long term corporate strategy. Microsoft, on the other hand, has turned to activist shareholder Carl Icahn, in the apparent hope that this will force a fire sale of Yahoo!'s core strategic search business.

Our priority is to build value for our stockholders. That continues to be our core mission. What we will not do, however, is allow our business to be dismantled or sold off piecemeal on terms that would be disadvantageous to Yahoo! stockholders and to the market as a whole. I trust that this will give you context to understand the extraordinary value we all place in the paid search portion of the online advertising business, and how very competitive it is and will remain. And why there are so many misconceptions - advanced by our competitors - about the agreement we have entered into with Google.

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Since quite a few misconceptions about this agreement have emerged, I think it is important to understand what **this agreement is <u>not</u>** as well as **what it is.**

First, this is not a merger. Far from it – we will increasingly compete with Google, and they with us. This is a commercial arrangement between two companies who will remain autonomous and compete aggressively -- in search and display advertising, mobile, news, e-mail, finance -- you name it. Yahoo! is here to stay and we intend to compete across countless platforms, including search, for years to come.

Second, Yahoo! is not exiting search, nor are we ceding any portion of that space to Google. This will not, as some claim, result in Google controlling 90% of the search business. To the contrary, we will continue to do everything we can to grow our share and also strengthen our competitiveness in search and search advertising. This deal is just one more important step along that path, and with all due respect to Google, we have every intention of fighting them and winning -- in this and in other areas, for years to come.

Furthermore, this agreement does not affect "algorithmic" search at all – when a user comes to Yahoo! and performs a search, the algorithmic results returned will still be entirely Yahoo!'s. Yahoo!

serves close to a quarter of the searches that consumers make today, and we expect to be serving that or more after this deal is implemented.

With respect to sponsored search and contextual advertising, this agreement simply allows Yahoo! to replace some of the ads we now sell—which, in practice, will likely be our least valuable ads—with more valuable ads that Google sells. One can think of this as opening up Yahoo!'s search results pages to competition from the ads that Google sells with the same search terms. In fact, the CEO of the world's fourth largest advertising company, Publicis, recently stated that his company is "happy" with the agreement primarily because both Yahoo! and Google "agreed to work … on an open platform." He further noted that "creating this so that it's a more open platform for search (ads) is a good first step."

This agreement also principally focuses on sponsored search and not the fast-growing and dynamic display advertising sector. We see online display as the likely destination for the billions of ad dollars that are beginning to flow from traditional advertising outlets like television, radio and newspapers onto the Internet. More significantly, we see an increasing convergence of the display and search space, and advertisers will increasingly seek ad packages that include both search and display. Yahoo! has invested hundreds of millions of dollars in developing technologies that will better serve advertisers in a newly converged marketplace, and the proceeds from this agreement will permit us to accelerate our efforts. Just this past year we purchased both Right Media and BlueLithium, additions to Yahoo! that represent significant investments in the future of our search and display advertising efforts.

Third, this agreement is non-exclusive and gives Yahoo! complete discretion over if, how, where and when we will choose to use some Google advertising on our sites. There are no minimum requirements either, and Yahoo! is free to make similar deals with other companies. In other words, this gives Yahoo! the option to show Google ads, but does not tie our hands in any important respect.

We are strongly competitive with Google for many search terms, and where that is the case it will always be more profitable for Yahoo! to sell its own ads rather than backfill with Google ads. We have every incentive to minimize over time how often we use Google ad results. As we continue to improve the performance and monetization of our own advertising, we expect to use Google's ads less and less frequently.

Fourth, The claim some have made that Yahoo! and Google are price-fixing is entirely false. Prices for search terms are set by open and fair market-based auctions, and advertisers only pay when consumers click on their ads.

This agreement is truly win-win – it benefits consumers, advertisers, publishers, and Yahoo!. We believe that this agreement will improve the experience for advertisers and for consumers, by making ads even more relevant to Yahoo! users. This, in turn, will mean a better experience for users who get more ads that interest them, resulting in more click-throughs, and a better experience for advertisers who will get a better return on their investment.

It's worth pointing out that a number of large advertisers have already spoken out in support of this agreement in recent weeks, and I'd like to submit a series of quotes from those advertisers for the record if I may. These advertisers, who understand the implications of the agreement, have determined that it will improve the value of their advertising. Advertisers are also realizing that pricing will remain competitive and will be set by an open and competitive auction process – not set by Yahoo! or Google, as some might have you believe. Advertisers will continue to bid in Yahoo!'s keyword auction and in others' auction marketplaces and will determine where the best value exists. The very nature of the marketplace ensures that prices will be fair.

And to address one last point on the agreement itself, since I know there have been some questions surrounding it, I want to make it clear that maintaining the privacy of our users will continue to be paramount. The privacy concerns raised about this deal that somehow Google and Yahoo! are merging vast databases of personal information are simply false. While we will share some search terms to obtain sponsored search results from Google, Yahoo! will not be transferring any personally identifiable information in connection with this agreement without user consent.

Before concluding, I think it is important to recall the history of Yahoo!'s efforts in the search space to best understand how and why we came to this agreement, and where we intend to go after it is completed.

When Yahoo! was founded some 13 years ago, the web was in its infancy and our two co-founders, Jerry Yang and David Filo, sought to create a catalog of interesting web sites to make surfing easier. Later, as the number of sites multiplied exponentially it became more difficult for any one site to track and categorize what was on the Internet. As a result, search began to play a larger role, and it became clear to us that we should be providing this service on our sites.

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Initially, we provided neither the algorithmic search results nor sponsored search advertising on our own. Before 2000, we outsourced our algorithmic search results to a number of different companies, ending with a company called Inktomi. From 2000 to 2004, we outsourced algorithmic search to a brand new company in the space. That company was Google.

Likewise, until 2003, Yahoo! outsourced its entire sponsored search advertising business to a company called Overture.

In 2003 and 2004, our company made a strategic decision to bring search and sponsored search in house. We bought Overture and proceeded to incorporate sponsored search into our own company. And we bought Inktomi and did the same with algorithmic search.

This strategic decision to produce our own search product and to serve our own sponsored search advertising has not changed. Contrary to claims that we are somehow exiting a long-term effort on search, we are in fact doing just the opposite, and are on the upswing of our efforts. It was only a few years ago that we took over search and search advertising for ourselves, and we have been investing hundreds of millions of dollars to make it better and better ever since. This deal is a

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continuation of that process, and one that will allow us to invest even more in this effort and other innovations in online advertising.

Competing in this rapidly-evolving space is not easy, but we are committed to doing so and we believe we are at the beginning of a revolution in online advertising that will transform the way businesses reach their customers. We want to remain at the forefront of this transformation because we believe we are extremely well-positioned to capitalize on the growth we expect the online advertising market will experience in the coming years.

Yahoo! has a number of exciting new technologies with the potential to revolutionize how advertisers and publishers connect with each other and with consumers. For example, just last week we announced BOSS, an open platform build-your-own search service, which we believe will unleash a wave of innovation. And our efforts to create a robust, open exchange to bring publishers and advertisers together are also well on their way. These efforts are consistent with our complete commitment to continued growth in search and display advertising.

With the additional operating cash flow from this agreement – anticipated to be between $250 million and $450 million in the first year

– Yahoo! will accelerate our innovation and better compete against Google, Microsoft, and others in the online advertising marketplace.

Over the coming weeks, Yahoo! will continue to work with our advertisers, our users, outside groups and government authorities to explain this agreement and address any questions about the facts of the arrangement. We have kept the U.S. Department of Justice informed every step of the way, and will continue to cooperate with them and this subcommittee. We are confident that the more one knows about this agreement, the more it becomes clear that it will increase competition, stimulate creativity and benefit consumers, advertisers and the online advertising industry overall.

Thank you again for inviting me to appear here today. I look forward to answering any questions you may have.

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Testimony of Tim Carter - AsktheBuilder.com
to the
U.S. Senate Judiciary Subcommittee on Antitrust, Competition Policy and Consumer Rights

"The Google-Yahoo Agreement and the Future of Internet Advertising"

July 15, 2008

I sincerely appreciate the opportunity to submit this testimony to the members of the US Senate. It is my hope that my comments will aid you in making an informed decision about this very important topic.

The future of Internet advertising is brilliant. In fact, some say it might possibly be one of the fastest growing segments of our national economy as we move forward. The proposed agreement between Google and Yahoo, as seen from my eyes as a consumer and an Internet publisher, is actually a very good idea. There are many, many more winners who benefit from this business transaction than those who make claims about being harmed.

Real Estate

In the most basic sense, this transaction is about real estate and eyeballs. Those of us who own and operate websites possess pieces of virtual real estate. In the physical world we live in, location, location and location are the three most important axioms in real estate. In the case of Internet websites, great location can be defined as a website that gets a substantial amount of traffic. A number of Internet-traffic-analysis companies, as of July 12, 2008, show Yahoo.com as being the number one website in the USA with respect to traffic or eyeballs.

The consumers whose eyeballs are viewing Yahoo's website are there for one of two reasons: they either have a problem or they have some time to burn and are looking for a little pleasure. But my personal research has indicated that far more people each day are on the Internet to solve problems.

Advertising Solves Problems

People like you and me have problems each day. We seek out solutions to those problems, and with the advent of the Internet, it has never been easier or faster to discover precise and accurate solutions to those problems.

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In my opinion, one of the reasons for Google's success stems from the fact they are an excellent matchmaker. They created a streamlined search engine that displays search results as well as contextual advertising that matches the **exact search term** typed by tens of millions of consumers each day, many of whom are your constituents. Google is not the sole search engine that does this. Many, if not all, of the other search engines such as Yahoo, MSN Search, etc. do the exact same thing.

The advertising that is part of the search results is purchased by small and large companies alike. To the best of my knowledge, this method of displaying a highly targeted ad is quite possibly the key component to the paradigm shift that is happening right now in the advertising industry. Never before could companies be in front of so many consumers who needed their product or service at that ***exact instant*** in time. The old methods of advertising usually had some type of delay built in.

But it gets better. A business like mine can buy these contextual ads with ease and a small budget. I have done it for years to market some of my own products. Using Google's system, and similar ones at other search engines like Yahoo, Microsoft Search and Ask.com, I can set my own ad rates, set my own daily budget, determine exactly who can see my ads, when they see my ads and track in real time the performance of my advertising dollars. No wonder growing numbers of businesses large and small are spending their money on Internet ads. They work, and they work very well.

Several weeks ago I testified in front of a US House of Representatives Subcommittee about online advertising and small businesses. One of my newsletter subscribers summarized how powerful online advertising is.

Ms. Rachael Kahne from Nashville, TN wrote, ".....I work for a small business whose bread and butter comes from online advertising. There's simply no other better, more viral way to get in touch with a targeted audience. Online marketing allows a business to track and target what is working, and what isn't. It's certainly one of the most cost effective solutions out there today."

Billions of dollars are being spent on Internet advertising, and the market is growing. It is growing because it is a win-win-win-win situation. Consumers who quickly solve their problems win. The company selling the solution to the consumer wins. The Internet company that sold the ad wins. And finally, a website that displays a syndicated ad wins.

Syndication of Advertising

I happen to write a syndicated newspaper column called ***Ask the Builder***. Syndication is a highly productive method of distribution. I write my column just once, yet it appears in nearly 100 newspapers each week. Content is not the only thing one can syndicate. You can syndicate ads as well as many other things.

Google, Yahoo and other different Internet companies discovered years ago that it can be beneficial to many to syndicate advertising. I display syndicated advertising on my AsktheBuilder.com website. These ads magically appear on the pages of my website because I copied and pasted small amounts of HTML or javascript code into the pages of my website. You know it's very easy to add this code if a builder like me can do it. My ads are supplied by Google, Kontera and Taboola. I am currently considering an additional company as well called Chitika. These are not the only companies that syndicate Internet advertising.

The real magic of the syndicated ads is they help me and many other websites to dramatically increase productivity. I don't have to worry about running a huge ad-sales team, creating programming infrastructure to display the ads and expanding my accounts payable and receivables department. That is all done by the company serving the ads. I can focus my talents on what I do best, which is create content. I'm not alone. Hundreds of thousands of websites can and do display syndicated ads from Google,Yahoo or a host of other companies that sell these online ads.

Maximizing Revenues and Returns

Yahoo has valuable real estate on their website pages that is seen by tens of millions of people each day. They can sell or lease that virtual real estate to whomever they please or even fill the space with things they create. I do the **exact same thing** at AsktheBuilder.com. I fill my pages with my written or video content, ads sold by others or ads I sell myself.

Yahoo is a public corporation. They need to do, in my opinion, what is best for their stockholders. If they can lease space on their website to some other company and derive revenue for doing virtually nothing, why would you or anyone stop them? Who is getting harmed? Surely not the people who are clicking the ads! They willingly clicked them hoping to discover a solution to the problem they have.

Let's take this one more step down the anti-trust pathway. When and where will you stop sliding down this slippery slope? I had a discussion with a fellow Internet entrepreneur about this topic. His name is Dan Gray, and he is a writer / Internet publisher like me. He said, "Tim, are you next? When you become the most powerful home-improvement website on the Internet, will the government come in and tell you that you can't display Google ads? If that were to happen, it would be the most un-American thing I could imagine."

Dan is right. Why would you punish a company or multiple companies for being successful when few, if any, are harmed in the process?

Summary and Conclusion

This hearing is being held in front of a Subcommittee that considers anti-trust issues. My recollection of what my grade and high-school history teachers taught me is still fresh in my mind. If memory serves me right, anti-trust actions were initiated when some company or a small group of companies enriched themselves at the expense of many others who were harmed financially by the actions of the company or companies. The subject is no doubt far more complex than that, but I feel my explanation is the lowest common denominator of anti-trust.

That can't be said about the proposed deal between Google and Yahoo. The tens of millions of consumers each day who visit the Yahoo website are going to see ads that solve their problems. Many will click those ads. Hundreds of thousands of businesses who sell the products and services to these consumers will increase their revenues when those ads are clicked. Those companies end up paying more taxes, and our economy grows.

Who is harmed in this transaction? Perhaps some other company or companies that decided to follow a different pathway in the business jungle. My father-in-law taught me long ago that there is no substitute for brains. Furthermore, during my own journey in the business world over the past 34 years, I've discovered that healthy competition is a great thing. I personally love to compete against other home-improvement websites as it helps keep me focused and in the zone.

This proposed deal has the potential to increase the revenues of Yahoo by hundreds of millions of dollars each year. The ad revenue that Yahoo receives from Google will flow into Yahoo with virtually no expenses. If the management of Yahoo is wise, they will reinvest this money back into their company to provide the healthy competition that we as consumers want and need. The deal may also force other companies in the Internet business world to work a little harder. My experience as a builder is that a little hard work never really hurt anyone.

Thank you again for taking the time to consider my opinions in this very important issue.

Tim Carter
Founder - AsktheBuilder.com

Statement of Matthew Crowley, Chief Marketing Officer, Yellowpages.com

before

The Antitrust, Competition Policy and Consumer Rights Subcommittee of the Senate Committee on the Judiciary

on

The Google-Yahoo! Agreement and the Future of Internet Advertising

July 15, 2008

Chairman Kohl and Ranking Member Hatch, AT&T appreciates the opportunity to present its perspectives on the important issues raised by the Google-Yahoo! search advertising agreement.

Competition from an independent Yahoo! is the only thing that keeps Google (which already accounts for about 70% of all search-advertising revenue) from achieving complete control over the online search advertising business. Google and Yahoo! portray their deal as a straightforward supplier arrangement that will benefit advertisers and ensure an independent Yahoo!. In fact, it would do nothing to ensure a vibrant, innovative, competitive check on Google's dominance – it would merely create a *de*pendent and atrophying Yahoo!.

As explained below, AT&T evaluated the Google-Yahoo! agreement from the perspective of both a large online advertiser *and* a search advertising marketing agent that helps thousands of small and medium-sized businesses place their ads on Google and Yahoo! From these perspectives, AT&T believes that the parties' optimistic portrayal of their deal is misguided.

Through this agreement, Yahoo! will turn over some material percentage of its search advertising inventory to Google and will, in turn, become dependent on payments from Google. If this is allowed to happen, it seems obvious that advertisers will have a diminishing ability to play Google and Yahoo! against one another in a competitive marketplace. The result, of course, would be less choice and higher prices for advertisers – especially smaller-scale businesses that do not have the heft or resources to ensure the best deal possible through the already opaque processes through which Google and Yahoo! sell search advertising. Moreover, the deal would dramatically lessen Yahoo!'s incentive to invest in its search advertising technology, leading to a downward spiral of decaying capabilities on Yahoo!'s advertising platform and eventual monopoly control over this important segment of the Internet marketplace by the already dominant player – Google.

Witness Background

My name is Matt Crowley and I am the Chief Ad Product and Marketing Officer for Yellowpages.com, a digital media/local search venture owned by AT&T. I am responsible for end-to-end marketing at Yellowpages.com, overseeing nationwide consumer and business marketing strategies. I have led Yellowpages.com's launch of a completely new website and platform, as well as the introduction of several mobile search applications. In addition, I oversee our Internet advertising product line that we offer primarily to small and medium-sized U.S. businesses. Yellowpages.com has grown to become the nation's most preferred Internet Yellow Pages.

I have over 18 years of experience in marketing, sales and general management in both online and offline environments. Prior to my current position with Yellowpages.com, I was responsible for Internet sales, marketing and product management for SBC's SMARTpages.com, as well as regional ad sales for Pacific Bell SMART Yellow Pages.

I hold a BA in Economics from the University of California, Irvine, and an MBA from the University of Southern California.

AT&T's Perspective On This Transaction

AT&T is one of the largest purchasers of Internet search advertising services. We spend many millions of dollars each year on search advertising to market our own products and services. Like most advertisers, we buy the vast majority of our search advertising from Google or Yahoo!

Through our Yellowpages.com subsidiary, we also purchase search advertising services from Google and Yahoo! on behalf of thousands of small and medium-sized businesses. Yellowpages.com is the online version of our paper Yellow Pages telephone directories, and, in addition to selling paper and online yellow pages listings to local businesses throughout the nation, we offer a service that makes it easier for them to market their products through search ads placed with Google and Yahoo! AT&T therefore has a strong interest in a competitive search advertising market in which independent search engine companies are competing aggressively for our own advertising business and for the advertising business of the many small and medium-sized businesses that we represent.

AT&T also has a strong interest in seeing Yahoo! succeed in the marketplace. Since 2001, Yahoo! has been our exclusive Internet portal partner. We have more than 14 million broadband Internet customers and more than 70 million wireless customers, and we are well on our way to a million customers for our new U-verse TV service. For all of these services, we rely upon Yahoo! for content, search capabilities and advertising. Thus, if Yahoo!'s agreement to turn over part of its search advertising business to Google were good for search advertising competition and good for Yahoo!, we would fully support it. Unfortunately, after careful consideration of what Google and Yahoo! have, and have not, disclosed about their agreement, AT&T has concluded that the agreement poses a significant danger not only to competition for Internet search advertising services and to the broader Internet economy, but to Yahoo!'s continued viability as a strong independent competitor to Google.

AT&T's Yellowpages.com Service

Yellowpages.com is a subsidiary of AT&T that provides a one-stop shop for the online advertising needs of small-and medium-sized businesses. Our core business is the online extension of AT&T's traditional yellow pages business – *i.e.,* the yellow pages phone books that local businesses use to advertise their products and services. An Internet user who visits the Yellowpages.com website can query our yellow pages listings for a particular type of business in a particular location, such as a local pizza parlor, and see the listings of local businesses that offer that product or service – just as a user of our paper directories can look up local businesses under service headings.

Yellowpages.com also serves as a search advertising marketing agent for small and medium-sized businesses, helping them place their ads on Google and Yahoo!. Small and medium-sized businesses need to reach consumers who may not specifically query yellow pages listings for a particular product, but they often do not have the resources or expertise efficiently to purchase search engine advertising directly from Google or Yahoo!. Successful search engine advertising requires expertise in choosing key words that match the advertisement and resources to monitor the extent to which the advertisement is being presented, whether users are clicking on it, and whether those "clicks" are translating into sales. Yellowpages.com helps these customers take advantage of the power of Internet search advertising by designing, purchasing, and monitoring an Internet search advertising strategy on their behalf. When it acts as a marketing agent for its small and medium-sized business customers, Yellowpages.com learns their needs and represents them in securing the most cost-effective and customer-effective placement of advertisements on Google and Yahoo!.

By making this targeted advertising readily available to small- and medium-sized businesses, Yellowpages.com places these "little guys" on equal advertising footing with some of the largest companies in the world. The importance to small and medium-sized businesses of having effective access to Internet search engine advertising cannot be overstated. Internet search advertising is one of the fastest growing and most effective forms of advertising today. It is often the most effective way for small and medium-sized businesses to attract customers who are interested in their products.

Perhaps more than anything, this role – effectively as an ad agency for thousands of small and medium-sized businesses – gives Yellowpages.com direct visibility into the detrimental impact of the Google-Yahoo! agreement for the online advertising ecosystem.

There Are Very Limited Choices For Internet Search Advertising Today.

Advertisers today have only two real choices for sponsored search advertising on the Internet: Google and Yahoo!. The No. 3 competitor, Microsoft, which has a single digit share of advertising revenues, simply lacks the scale and capabilities of Google and Yahoo! in this area and has been losing ground. Nos. 4 and 5, AOL and Ask.com, are not even independent competitors – they both already rely upon Google.

Yahoo! has, so far, managed to hold its own against Google. But this is a critical time in this market, and if Yahoo! is weakened, loses focus, slows down on investment or innovation, or does anything but continue to compete all out to best Google, there is a real risk that the market will tip even further toward Google. No one in the industry wants that to happen. Without robust competition from Yahoo!, there would be little to stop Google from gaining bottleneck control over search advertising.

The Google-Yahoo! Agreement Implicates Services that are Essential to Internet Growth and Innovation.

Two related phenomena have contributed heavily to explosive Internet growth over the past decade: (1) the development and enhancements of search engines that allow consumers to search the Internet effectively and without incurring any charges, and (2) the growth in the number and quality of websites maintained by myriad online "publishers" that consumers locate (often through search engines) to obtain information, services or entertainment and can visit without incurring any charges.

Online advertising provides the revenue that enables these free services to be offered, developed, and improved. Search advertising is, by a wide margin, the largest category of online advertising. And Google and Yahoo! are, by a wide margin, the two largest players in this highly concentrated market – with Google the clear leader, accounting for the vast majority of all search advertising revenues, and the two together now representing about 90% of the market.

As independent competitors, Google and Yahoo! each invests heavily to improve its search and search advertising algorithms, processes and business models to attract a greater share of enormous amounts online advertisers are willing to spend. It is extremely important that nothing be allowed to interfere with the intense competition that fuels this innovation, because improvements in this area will benefit all Americans in the form of lower prices and better service.

Incentives to innovate and improve search advertising are maximized in a market structure with multiple large, independent search advertising competitors. The ability to make improvements in ad placement and search technologies is heavily influenced by the number of searches and advertising transactions a search engine handles. In economic terms, the search-related advertising business is characterized by strong scale economies. A search engine that handles more searches and search advertising transactions will generally have better capabilities to match user searches with relevant ads today and more of the data that it needs to inform the changes and innovations to its ad platform that will improve its ability to do so in the future. By contrast, a search engine that loses "scale" in these respects may be disadvantaged in its ability to compete for advertising dollars today and to improve its capabilities for the future.

Competition between Yahoo! and Google for the billions of dollars that online advertisers spend annually also fuels investment and innovation across a wide range of other Internet activities, and a competitive online advertising market is thus vitally important to the U.S. economy. Free e-mail, instant messaging, mapping, online storage and many other Internet services and features are all products of unbridled competition for advertising dollars. Online publishers also make most of their money from advertising, and the share of search advertising revenue they can negotiate for agreeing to display a search engine toolbar – and thus what they have available to fund new content and services – depend upon intense competition between Google and Yahoo!

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How Google and Yahoo! Sell Search Advertising

Not only are Google and Yahoo! the dominant providers of sponsored search advertising, but they are already able to price their services in an unusually opaque manner. This makes it harder for Yellowpages.com to assist our small and medium-sized advertising customers and harder for all advertisers to ensure that Google and Yahoo! compete against one another. Google's increased dominance as a result of this deal would make this problem worse.

Advertisers seek to ensure that Google and Yahoo! compete by carefully monitoring the cost effectiveness of their ad placement services and shifting advertising dollars as a result. Today, Google and Yahoo! compete head-to-head to do a better job than the other at efficiently placing advertisements on the pages where customers are most likely to click the advertisement. Google and Yahoo! today have completely separate technology processes (or algorithms) for matching advertisements with searches and determining the placement on the results pages a particular advertiser will receive. Google's sponsored search process is branded "Adwords," and Yahoo!'s is branded "Panama."

Knowing that prices reflect the services provided is crucial to monitoring competition between Google and Yahoo!, but this is often difficult even today and would become even more so after the deal. In this regard, statements by Google and Yahoo! that customers control the prices in the "auctions" they hold for search keywords are misleading. In fact, Google and Yahoo! retain ultimate control over the amount that particular customers must pay to receive service through manipulation of the number of ad "slots" available to interested advertisers, the "reserve" prices – or minimum bids – for those advertising slots, and the opaque "quality score" rankings that determine which paid ads will be delivered with search results, the order in which they will appear, and how much advertisers will pay per click.

Competition from an independent Yahoo! now reduces the dangers posed by Google's dominance and pricing system. Even so, Google's "Adwords" algorithms lack transparency; Google's prices are already generally higher than Yahoo!'s; and we have found Google to be more inflexible in terms of negotiating terms and conditions for commercial agreements.

The Google-Yahoo! Deal Threatens to Dramatically Reduce the Competition that is Essential for Internet Growth and Innovation.

The essence of the Google-Yahoo! agreement is that the No. 1 and No. 2 competitors today in search advertising have entered into an alliance whereby Google will provide the ads for an unlimited portion of Yahoo!'s search queries in the United States and Canada. Through an undisclosed method, Yahoo! will select the most revenue-enhancing ads from between the two platforms and post those ads alongside its search results. When Yahoo! uses Google ads, Google will pay Yahoo! an undisclosed share of the revenue from ads served by Google.

This arrangement will essentially displace a significant portion of the advertising inventory supplied by Yahoo!'s ad platform, Panama, which is the only truly viable long-term competition for Google's search platform. The attractions of the deal to Yahoo! are obvious – it makes more money from turning over some of its search ad inventory to Google and hopes to scuttle a deal with Microsoft. For Google, the deal is a way to limit the capabilities and dull the competitive focus of its main rival in this business.

AT&T has two major concerns with the Google/Yahoo! agreement:

First, this agreement will lead to higher prices for sponsored search advertising services. There is very little choice in this market today, and now Google and Yahoo! propose that Yahoo! be allowed to turn over a large portion of its inventory to Google and to become dependent on payments from Google. Advertisers' ability credibly to threaten to shift more of their business to Yahoo! is really the only thing that keeps Google in check today. If Yahoo! is filling fewer advertising slots on Internet search pages (and Google more), we expect that the prices advertisers have to pay to get slots will go up – both on Yahoo! and on Google, which is already generally more expensive than Yahoo! Higher prices and costs for Internet search advertising would, of course, mean higher prices for the products and services that are marketed through such advertising – today, almost everything.

Second, this agreement will substantially and quickly weaken Yahoo! as a competitor, giving Google even more power in this market. If Yahoo! hitches its wagon to Google, takes a stake in Google's profits, and turns over a significant portion of its business to Google, that will lessen Yahoo!'s incentives – and its ability – to invest and innovate to win business away from Google. Success in the search advertising business requires constant investment and innovation, and this deal will clearly handicap Yahoo! in those areas. The fewer advertising transactions a search engine handles, the less information it has to inform decisions how to make its search advertising processes more effective – and the smaller the base of transactions it has over which to spread the costs of that innovation.

To make matters worse, the revenue-sharing deal with Google will also lessen Yahoo!'s need to make risky investments to improve its capabilities – Yahoo! would share in Google's success. AT&T therefore views this agreement as sending Yahoo! on a downward spiral as an ever-decreasing competitive threat to Google. We have already seen that with AOL and Ask.com after they turned over their search advertising business to Google.

A weakened Yahoo! will turn down the competitive heat on Google even further. Google already controls the lion's share of this business, and we see the consequences of its dominance in the form of higher prices, less transparency and an "our way or the highway" attitude. Anything that weakens Yahoo! or causes it to lose competitive focus is thus a major concern.

Indeed, according to internal Yahoo! documents made public in a shareholders' lawsuit, Yahoo! leadership rejected the idea of outsourcing its search-advertising business to Google earlier this year for precisely this reason, concluding: "We are focused on long-term value creation rather than short-term gains (short-term analysis of the revenue potential of outsourcing monetization may not take into account the longer term impact on the competitive market *if search becomes an effective monopoly*)."

As noted, the impacts of this agreement go well beyond search advertising. Intense competition between Google and Yahoo! for the billions of dollars that advertisers spend on online advertising is the engine that drives innovation and investment not only in the search advertising business, but in a broad and growing range of Internet activities.

We believe that you will conclude, as we have, that the agreement will reduce competition and harm consumers, advertisers and the Internet marketplace. AT&T therefore urges the Subcommittee to take a very hard look at the Google-Yahoo! agreement; insist that the parties disclose much more about its terms and likely impacts; encourage the relevant regulatory authorities to scrutinize this proposed deal with the same rigor as they would a merger of the two companies; and ensure that, should the deal proceed, it be subject to adequate checks and modifications to protect against harm to consumers and businesses, including the thousands of small and medium-sized businesses that rely so heavily on search advertising as a competitive lifeline to their customers.

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Google™

Testimony of David Drummond
Senior Vice President of Corporate Development and Chief Legal Officer, Google Inc.

Before the Senate Committee on the Judiciary
Subcommittee on Antitrust, Competition Policy and Consumer Rights
Hearing on "The Google-Yahoo Agreement and the Future of Internet Advertising"
July 15, 2008

Chairman Kohl, Senator Hatch, honorable members of the Subcommittee, my name is David Drummond, and I am Google's Senior Vice President of Corporate Development and Chief Legal Officer.

Thank you for inviting me to discuss our recent agreement with Yahoo! and the future of Internet advertising. Because of its founding principles of openness and interoperability, the Internet is an extraordinarily competitive environment, where competition and choice are only a click away. Consumers, creators, and entrepreneurs come together online to communicate and discover information, create and distribute new types of content, and develop and expand new business opportunities. Online advertising is playing a critical role in fueling economic growth and furthering innovation across the Web, benefiting users, promoting free speech, and helping businesses of all sizes succeed.

My message to you today is simple: While there are other threats to the continued competitiveness of the Internet, the online advertising marketplace is competitive, robust and dynamic. Our recent advertising agreement with Yahoo! will maintain and expand that competition, while growing the reach of consumers' favorite instant messaging chat programs. As I will explain, the non-exclusive commercial arrangement creates new efficiencies that make the pie larger, benefiting users, advertisers and publishers, while protecting privacy and spurring innovation.

Yahoo!'s Advertising Agreement with Google:
On June 12th, we announced a non-exclusive advertising agreement giving Yahoo! the option to display Google-supplied ads alongside Yahoo!'s search results, web pages, and partner properties in the United States and Canada. Yahoo! can use Google ads on as many or as few of its search result and content pages as it chooses. The agreement lasts for four years, and can be renewed for two additional three-year terms.

The agreement will not affect Yahoo!'s natural search results. Yahoo! will continue to operate its own search engine and display natural search results in the same manner it does today. The arrangement therefore will not increase Google's share of search traffic, contrary to some claims.

This arrangement is not a merger, nor a joint venture. It is much simpler than that - it is a non-exclusive agreement to supply advertising. Google is providing access to our back-end search and contextual advertising systems to Yahoo! We currently provide these services through our AdSense for Search and AdSense for Content programs to sites like WashingtonPost.com and Ask.com, as well as many other partners. Moreover, this is a non-exclusive agreement. Yahoo! could enter into similar arrangements with any other company, including Microsoft. Indeed, Yahoo! can - and will - continue to supply much of its advertising through its own internally developed ad platform.

We are not required to receive approval from antitrust authorities prior to implementation. We notified the Department of Justice (DOJ) in April, when we conducted a limited two-week test of Yahoo! running Google ads. We stayed in contact with DOJ, and voluntarily agreed to delay implementation for three-and-a-half months, giving regulators time to understand the arrangement.

Benefiting Consumers, Website Owners, and Advertisers:
Why did Google enter into this agreement? We think we'll make money of course, and we think we'll do so by giving millions of consumers, publishers, and advertisers access to more relevant online ads. Where Google's system may provide better results, Yahoo! will be able to use it to complement its own advertising program. The whole system becomes more efficient: people see and click on more ads that are useful to them, publishers get more revenue from ads on their sites, and advertisers get more potentially interested customers. This is not unusual – a large portion of Google's business is simply to partner with thousands of diverse website owners and, in return for a small portion of the revenue, provide these web publishers with ad services.

Consumers
Consumers will not only get better, more interesting ads, but also benefit from continued online competition and innovation. Users value ads that connect them to the information, products, and services they seek. This is the driving philosophy behind Google's advertising business – we strive to deliver ads that are the most relevant to our users, not just the ones that generate the most revenue. We do this through our innovative ad auction system, which factors in the relevancy, or usefulness, of the ad to our users.

Here's how it works: Through a simple online interface, advertisers create short text ads for their products and services and choose associated keywords. Advertisers then place bids indicating how much they are willing to pay if a user clicks on their ad. When a user enters a word or phrase (referred to as a "query") into our search engine, our technology matches the words with those entered by advertisers and selects ads that will appear above or to the right of the search results. The ads are selected and ranked based on advertisers' bid prices, along with a quality score factor. Most search advertising systems now use a measure of ad quality, which provides an incentive for advertisers to show useful ads and reduces ad spam, which is distracting and frustrating for consumers. Advertisers typically pay us only when someone actually clicks on their ad. When Google supplies ads to our content partners' websites, the ads are matched based on search terms or the content of the page displaying the ad.

Google has built a sophisticated tool for matching search queries to highly relevant text ads, and we're constantly experimenting with new algorithms to show users relevant ads. The benefits of our ad system can now be extended to Yahoo!'s users. Consumers will see ads that are better targeted, which will help them get where they want to go online.

The arrangement will also help Yahoo! remain a vibrant and innovative presence on the Internet. Yahoo! may find that its own advertising platform generates similar revenue on much of its search traffic, and thus not want to use Google for those searches, as that would result in sharing revenue that Yahoo! could otherwise keep fully. For the ads that are supplied by Google, if users find them more useful and click on them more often, this will give Yahoo! additional revenue to invest in its own search engine, advertising tools and other services. That should benefit Yahoo!'s content portal, email, instant messaging, productivity software, photo sharing service, music services, games, finance offerings and all the other products and services Yahoo! offers.

Website Owners
Online publishers (website owners who earn revenue by running syndicated ads from companies like Google and Yahoo!) will benefit from better ad matching technology, potentially increasing the revenue they earn from their site. Simply put, if an ad is better matched to the content of a particular web page, a user is more likely to click on the ad, resulting in more revenue to the owner of the website where the ad appeared.

Google partners with thousands of web publishers, large and small, to place ads on their web pages. Much of Google's success is based on the success of our business partners. When a visitor to our partner's site clicks on a Google-supplied ad, Google shares a majority of the advertising revenue with the website operator. In 2007, we paid out $4.5 billion in advertising revenue back to our partners. A significant portion of that revenue went to small businesses, including bloggers and web entrepreneurs. In this way, online advertising promotes freer, more robust, and more diverse speech, and lets small businesses across the country compete in the global marketplace.

The arrangement lets Yahoo's content partners benefit from Yahoo's ability to use Google-matched ads. Publishers may find that visitors click on their site's ads more often, generating more revenue.

Advertisers
Lastly, advertisers will benefit from better ad-matching capability, giving them improved ways to reach online customers more efficiently.

Google does not control the prices charged to an advertiser when a user clicks on a Google ad. Rather, advertisers themselves determine prices through an ongoing competitive auction for particular keywords. We have found over years of research that an auction is by far the most efficient way to price search advertising and we have no intention of changing this approach.

Advertisers care most about the number of users who ultimately buy the product or service being sold or consumed on their website. The famous department store pioneer John Wannemaker once said that "half the money I spend on advertising is wasted; the trouble is I don't know which half." Online advertising helps solve that problem, by letting advertisers pay only for ads that are of interest to their target audience. The more likely an ad is to result in a user buying something, the more valuable that ad is to the advertiser.

Large and small advertisers have indicated that the arrangement with Yahoo! will benefit them

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because Google will better match ads to web users who want to purchase the advertiser's goods or services. Here's what advertisers and other ad industry participants are saying:

- "*[The agreement] is something that isn't threatening to clients, they are not merging, they are independent and they remain competitors. . . . I view it as very positive.*" Maurice Levy, Chairman and CEO, Publicis Groupe (the Guardian, 6/20/08)

- "*The agreement between Yahoo and Google should help the relevancy of our advertising on Yahoo, which should actually make the dollars we spend more efficient.*" Geoff Atkinson, Vice President of Tactical Marketing at online retailer Overstock.com (Bloomberg, 6/20/08)

- "*We are happy with that agreement. . . . It's not a lack of competition.*" David Kenny, CEO, Digitas Inc. (Reuters, 6/20/08)

- "*What it will ultimately do is allow us to get broader distribution out of Google's ad platform. . . . [The partnership] is going to be good news for advertisers.*" Matt Greitzer, Vice President of Search Marketing at Avenue A/Razorfish, acquired by Microsoft through its purchase of aQuantive (Bloomberg, 6/20/08)

When Microsoft's own ad firm – the group within Microsoft that knows online advertising best – confirms the benefits of the agreement for advertisers, we should rest our case right there.

Fostering Competition in the Dynamic Online Advertising Space:
The arrangement will also promote competition and innovation. Google and Yahoo! will remain vigorous competitors, and that competition will help fuel innovation that is good for users and the economy.

Unlike other alternatives, such as Microsoft breaking up Yahoo! by acquiring Yahoo!'s search assets or taking over all of Yahoo!, this arrangement will not remove a competitor from the playing field. Yahoo! will continue to operate its own search engine, ad platforms, and web properties, will continue to control its user interface and the display of advertising on its site, and will maintain relationships with its own advertisers. Indeed, for any given search query, Yahoo! could, for example, choose to keep prominent ad placements for its own ad system and its own advertisers, while using Google's system to supply lower ranked ads. Advertisers using only Google's system will not be guaranteed in advance particular placements on Yahoo! We fully expect that advertisers using Yahoo!'s system today will continue to do so after the agreement is implemented.

Yahoo! has indicated that not only will it continue to use and promote its own search advertising platform, but that the revenue from this arrangement will fuel continued investment and improvement in its platform. Yahoo! will also need to continue using its own ad system outside of the United States and Canada, in supplying ads to new content partner sites worldwide, and in supplying ads to mobile users, a rapidly emerging growth area for online advertising. Moreover, Yahoo! and Google will continue to compete across a wide variety of other products and services, giving both companies an incentive to keep improving and innovating.

Supplier arrangements are commonplace in many industries. For example, Toyota sells its hybrid technology to General Motors, even though they are the number one and number two car manufacturers globally and compete vigorously. Canon supplies laser printer engines to Hewlett Packard, while also competing in the sale of laser printers. Despite the fact that an underlying service or technology is supplied by a competitor, these and many more examples show that companies can compete aggressively even with their partners.

Outsourcing arrangements have been a common feature as web search has evolved. Yahoo! used Google's search engine to generate its search results until 2004, when Yahoo! transitioned to the search engine that it had developed. Through an ad company it acquired called Overture, Yahoo! also supplied advertising for Microsoft's search site until 2006, when Microsoft phased in its own system.

We are not aware of any similar non-exclusive arrangement that has been blocked by antitrust authorities. As a starting point, DOJ recognizes that competitor collaborations can have pro-competitive benefits. In fact, the Antitrust Guidelines for Collaborations among Competitors, issued by DOJ and the Federal Trade Commission in 2000, state as a matter of principle: "In order to compete in modern markets, competitors sometimes need to collaborate. . . . Such collaborations are not only benign but pro-competitive." The Guidelines recognize that consumers may benefit, especially if, as here, one company has technical expertise that enables another participant to lower its production cost or improve the quality of its product. With its non-exclusive terms and the fact that Yahoo! will remain a strong competitor in this space, we are confident that this arrangement will promote competition, innovation, and consumer choice online.

The Online Advertising Marketplace is Robustly Competitive Today:
Online advertising is critical to the continued growth of our economy, and beneficial to consumers. Although online advertising is a small piece of overall advertising dollars, it is characterized by strong competition, significant innovation, and tremendous growth. Brian McAndrews, Microsoft's Senior Vice President of the Advertiser and Publisher Solutions Group, has commented that the online advertising space is "in the first or second inning of a long game here. There's no monopoly on innovation. I don't think you're going to see two or three big players and then game over. There will continue to be a broad range of companies." (MediaPost, 6/15/07)

There are many formats for online advertisements, including text, display, and rich media ads, and also many ways ads can be matched to users, most notably through search terms, contextual matching, behavioral targeting, and demographic targeting. Google has focused on search-targeted text-based ads. Display advertising – static or moving images that appear on a website you're visiting – are also common. Yahoo! has one of the leading display ad platforms in the world. Advertisers increasingly use multiple forms of online advertising, and multiple targeting technologies. For instance, advertisers and publishers who work with us have asked us to complement our text-based advertising with display advertising to support multi-format campaigns. We know that Microsoft, Yahoo!, AOL, WPP and countless others are building out their array of capabilities as well.

The online advertising space is marked by strong competition. There are thousands of companies selling online advertising, including websites that sell ad space directly and intermediaries. Last year saw several major transactions and capital infusion of more than $10 billion. Microsoft, for example, spent $6 billion to acquire the online ad firm aQuantive. These acquisitions are strong signals that the market believes this space has significant room for growth and competition.

More players and more capital are combining to create not only more competition but also more innovation in technologies and business models. Facebook, for example, is experimenting with ways to target advertising to its 80 million active users, aided by Microsoft, which is the exclusive third-party supplier of ads for the social network. With its goal of creating an advertising platform across devices and media (including TV and gaming), Microsoft is aggressively taking steps to grow its search and advertising capabilities. Capitalizing on 2007 annual revenues of $51 billion, Microsoft last month launched a search cash-back program through which searchers can earn cash back from Microsoft for eligible purchases. Clearly, this is an area in which Microsoft expects to compete aggressively for a long time to come.

Google will Continue to Protect Online User Privacy:
Google believes deeply in protecting the privacy of our users. We design our policies and products in way that provides transparency, choice, and security for user data.

Google was the first leading Internet company to decide to anonymize IP addresses and cookies (very small files stored on your computer to, for example, remember language preferences). We've also decided that our cookies will expire after two years of inactivity. We continue to innovate in our privacy protection practices. For example, we're exploring better forms of notice within display ads, which we think would benefit consumers if offered industry-wide.

Google is also committed to industry best practices – including the privacy guidelines of the Network Advertising Initiative – and to continuing to work with the Federal Trade Commission to develop workable and widely-adopted behavioral advertising principles. Google supports passage of a comprehensive federal privacy law that would enhance consumer trust and protections, establish a uniform privacy framework, and penalize and dissuade bad actors.

Every day we spend significant time and resources designing products on the principles of transparency, choice, and security - transparency about what information we collect and how we use it, user choice about whether to provide us with personal information at all, and security to protect information stored with us. We lead the industry in making our privacy notices and education efforts clear, concise, and understandable. Many of our products are designed to let people use them anonymously. None of our products use any personally identifiable data unless fully disclosed in our privacy policy.

We have taken a number of steps in the Yahoo! agreement to protect user privacy. As Google supplies ads to Yahoo! and its partners, personally identifiable information of individual Internet users will not be shared between the companies. Yahoo! will also anonymize the IP address of a Yahoo! searcher's computer before passing a query to Google. Moreover, Google will not provide real time pricing data to Yahoo! and will restrict the information that Yahoo! receives when a user clicks on an ad supplied by Google. These enhanced privacy firewalls demonstrate how vigorously the companies plan to continue competing against one another.

Interoperable Instant Messaging Will Benefit Users:
Google is particularly excited for our users that as part of this agreement, Yahoo! will make its instant messaging (IM) network interoperable with Google's. This will mean easier and broader communication among a growing number of IM users, and enable users to choose among competing IM providers based on the merits and features of the services.

Unlike email, not all instant messaging networks are interoperable. Microsoft and Yahoo!, the two leading global IM providers, made their IM systems interoperable in 2006. In contrast to other leading IM systems, the Google Talk IM network is built on an open, standards-based IM protocol. Yet, neither Microsoft nor Yahoo! are interoperable with Google's IM systems.

The lack of IM interoperability has broader implications for competition on the Internet. As websites become more interactive and users more familiar with online chat, the use of instant messaging is growing at home and at work. Rather than walled gardens, interoperability benefits users by breaking down barriers to communication with users of other systems. With interoperability, users can exchange messages across networks, see friends' online presence, view status, and add contacts from either service. This brings more control and convenience to users.

Ensuring Continued Competition on the Internet:
Competition on the Internet is thriving today because, with a few notable exceptions, most Internet companies are staunchly committed to basic principles of openness and interoperability. The web's open standards and protocols allow users to use any browser on any operating system to visit any web site. In the next phase of the Internet's evolution, known as "cloud computing," users increasingly will manage and store their files online, rather than through software stored on their PCs. All consumers will need to access and use their information is a simple device that can connect them to the Internet.

Openness and interoperability are central to Google's mission to organize the world's information and make it universally accessible and useful. Like many companies, we provide Internet users with a variety of products and services, most for free, that let users share, receive and organize digital information - from our search engine to Google Maps to YouTube. We also offer Google Apps, a web-based suite of collaborative productivity tools (*e.g.*, email, calendar, word processing, spreadsheets and presentation software), which provides a cost-effective solution that is popular with small businesses. Google is not alone, as established companies and Internet upstarts alike are heavily investing in revolutionizing the next wave of innovation online.

Unfortunately, some of our competitors have a fundamentally different approach to competition, one that promotes closed systems and limits consumer choice. On the desktop, too often users are trapped within the confines of a single operating system, word processor, or web browser. Dominance of the desktop can let one company favor its own products and services and obstruct the interoperability of competing products or services, overriding the desires of consumers.

Microsoft continues to maintain dominant positions in desktop computing that could be leveraged to harm competition online. For example, Microsoft maintains more than 90% share in operating systems, more than 95% share in productivity applications through Windows Office, and approximately 80% share of the browser market through its Internet Explorer browser that comes

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bundled with its other software. Microsoft has a long history of abusing and extending its dominant positions through anticompetitive practices. Seeking to control technical standards or deny interoperability, Microsoft often abuses the licensing process, reveals less than complete information, or prevents data portability. While it's easy to imagine using a different search engine – others are just one click away, and millions of people use different search engines every day – Microsoft has locked consumers into its PC-based software monopolies. For years, Microsoft has been working to leverage that lock-in onto the freer and more open world of the Internet.

Despite publicly proclaiming a new attitude toward opening its products, Microsoft frequently returns to its old habits. Just last year, Microsoft tied its own desktop search into its new Vista operating system, with no way for users to choose an alternate provider from numerous built-in shortcuts. State antitrust regulators stepped in and Microsoft ultimately made some changes to give users partial choice. Similarly, Microsoft's Internet Explorer browser was set up with defaults to send users to Microsoft's search service, until the European Commission stepped in to block Microsoft's attempted tying. Microsoft is currently being investigated for using improper tactics to manipulate the vote of an international standards body. These are troubling examples of Microsoft's longstanding practice of using its control over desktop computing to harm competition.

As you consider the state of competition on the Internet, this Committee should ensure that Internet users remain in control of their Internet experience. Be wary of a company's attempt to restrict user choice. Companies should compete for users based on the quality of their services, and the innovation they create. That has been the hallmark of the Internet's transformative power as a medium for free expression and economic growth. As the web evolves to become even more interactive and more useful than it is today, we should demand no less.

I appreciate the opportunity to share our view of the competitive dynamics at work on the Internet. Thank you.

United States Senate
Committee on the Judiciary

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Statement of

The Honorable Herbert Kohl

United States Senator
Wisconsin
July 15, 2008

Today we examine the internet advertising market. We have read daily news accounts of Microsoft's efforts to buy all or part of Yahoo, and proxy wars being fought for control of Yahoo's future. No one knows the outcome of those events. But today we will examine what we do know. Google and Yahoo – the two largest competitors in search-based advertising – have reached an agreement where Yahoo will outsource a portion of its advertising business to Google -- and the two companies will split the proceeds. Yahoo contends that this will add $800 million annually and enable them to become a stronger, independent competitor to Google.

Critics, on the other hand, ask how the agreement could possibly be good for competition. They argue that Google is paying its largest competitor a premium not to compete as vigorously as Yahoo had previously. And, the higher ad rates it will earn will encourage Yahoo to compete even less. So, we are forced to ask today whether this agreement will reduce Yahoo to nothing more than the newest satellite in the Google orbit.

While we will need to study this deal carefully, what is indisputable is the vital importance of internet advertising to the national economy. As we increasingly rely on the internet for commerce, entertainment, communication and news, advertising on the internet has become ever more essential to business. In 2007, more than $ 21 billion dollars were spent on internet advertising in the United States, more than the amount spent on advertising on cable TV, broadcast TV networks, radio, or billboards. And it has tripled in just the last five years.

Google, Yahoo, and Microsoft perform essential functions. Not only do they serve as gateways to the internet, but in doing so, they help businesses and consumers find each other with the most relevant advertising ever seen.So the stakes are very high in maintaining a vibrant and competitive internet advertising sector. One type of internet advertising – the advertising that is displayed with internet searches – is particularly impacted by the Google/Yahoo deal. The two companies together have a 90% market share in internet search advertising, with Google alone controlling more than 70% of the market.

In examining the competitive impact of this deal, we will need to find answers to a number of important questions. What will be the effect of Yahoo outsourcing a portion of its search advertising to its biggest competitor? Will it lead to higher advertising rates, or will it work to advertisers' benefit by giving them a bigger audience? Do other types of internet advertising factor into this equation?

The history of the development of the computer industry gives us reason to be cautious as we evaluate this deal. A decade ago, today's witness Microsoft, came dangerously close to quashing competition throughout the high tech economy. We're pleased that Microsoft has reformed its business practices. But this experience teaches us the importance of acting, and acting early, to ensure that competition is preserved in this vital sector of the economy.

United States Senate
Committee on the Judiciary

< Return To Hearing

Statement of

The Honorable Patrick Leahy

United States Senator
Vermont
July 15, 2008

Statement of Senator Leahy
Chairman, Senate Judiciary Committee
Hearing on "The Google-Yahoo Agreement and the Future of Internet Advertising"
July 15, 2008

The Internet has opened new means of communication, new ways to promote ideas, and new ways to buy and sell products and services. The explosion of free and easily accessed content on the Internet has been driven by a successful and competitive online advertising industry.

The online advertising industry in the U.S. reportedly surpassed $21 billion last year. As more people use the Internet more often and with increased purposes, advertisers will similarly move to online platforms to move their message. The issue for the Committee today is whether these advertisers - be it Orvis or the Vermont Teddy Bear Company -- will find options at competitive prices.

Business on the Internet is dynamic. The antitrust laws, rooted as they are in the fundamentals of competition in innovation and pricing, are nimble enough to keep up with changing business models and technology.

The resolution of the drama being played out in the courting of Yahoo by both Microsoft and Google will have lasting effects. The Google agreement with Yahoo may relate only to text advertisements, but if it stifles competition in this market, that will quickly spill into emerging online ad markets such as delivery to mobile devices.

The ability of a single company to dominate the online advertising marketplace also raises the specter that one company will accumulate vast amounts of personal viewing data. This leads to significant privacy concerns, an issue on which I will remain focused as the online advertising market continues to develop.

The Antitrust Subcommittee has taken a leading role in examining competition issues surrounding online advertising. I thank Senator Kohl for staying vigilant to ensure competition remains vibrant, and for holding this timely and important hearing.

I look forward to hearing from our distinguished panel of witnesses today.

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SBE COUNCIL
Small Business & Entrepreneurship Council

July 14, 2008

The Honorable Herb Kohl
Chairman
The Honorable Orrin Hatch
Ranking Member
Antitrust, Competition Policy and Consumer Rights Subcommittee
Committee on the Judiciary
United States Senate
Washington, D.C. 20510
VIA FACSIMILE: 202-228-2294

Dear Chairman Kohl and Senator Hatch:

The Small Business & Entrepreneurship Council (SBE Council) has been monitoring the development of internet search and search engine advertising as use of the internet has exploded and matured. Internet affordability, accessibility and vibrant innovation remain critically important for small business growth and competitiveness. Naturally, affordability and access to online advertising and internet search advertising is an important issue for entrepreneurs and the health of their firms as they increasingly utilize these tools to find new customers.

In analyzing the Google-Yahoo! agreement, and given there is marginal competition in the internet search advertising sector -- as well as the current barriers that exist for small business owners in where they are listed with respect to search page results (and the necessity to invest in paid keyword ads) -- the agreement between these two dominant players has raised the following set of questions for SBE Council and we hope the committee explores these issues in your hearing on July 15, 2008:

• How will the Google-Yahoo! agreement lead to greater value for small business advertisers – e.g.: more options and choices, better prices, quality of service and effective advertising results?

• Given the mysterious process that currently exists for small businesses in how Google and Yahoo! sell their advertising, how will this agreement make the process more clear for these advertisers?

• How will the deal lead to greater innovation and investment by the companies to improve and enhance internet search advertising for small firms?

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(page 2 – Senator Kohl and Hatch, July 15 hearing)

• With success in the search advertising business requiring an ongoing flow of investment dollars, how will Yahoo! remain incentivized to stay competitive (invest and innovate) given the deal structure with Google?

• How do Google and Yahoo! view the competitive environment in their industry? Given the 90 percent market share that the companies will have with the agreement, do they really feel they are competing against other independent search engine companies – or, for that matter with each other – given the structure of their deal?

• Small companies are already disadvantaged when it comes to the online model that search engines employ for advertising – how will this improve? Or, does this matter to the companies (e.g., Google) that sell the advertising?

Indeed, the internet has been a great equalizer in allowing small businesses and entrepreneurs to compete with larger players, and in the global marketplace. The internet has enabled many small business owners to grow, go global and develop new markets because of its affordability, and consumer accessibility to a greater number of businesses offering products and services.

We need to maintain a vibrant and competitive internet in order to help small firms keep doing what they do best – that is, innovate, create jobs and produce products and services that provide more choices and better value for consumers.

The agreement between Google and Yahoo! is one that raises concerns with respect to costs, accessibility and barrier to entry issues for potential small competitors. We are hopeful that the hearing today will shed light on these matters, as the SBE Council continues to explore the issues and answers as well.

Please do not hesitate to contact SBE Council if you have questions. Thank you for your leadership, and support for small business.

Sincerely,

Karen Kerrigan
President & CEO

cc: Senate Judiciary Committee Members

Testimony of Brad Smith
Senior Vice President and General Counsel of Microsoft
Senate Judiciary Committee
Subcommittee on Antitrust, Competition Policy and Consumer Rights

Hearing on The Google/Yahoo! Agreement and the Future of Internet Advertising

July 15, 2008

Chairman Kohl, Ranking Member Hatch, and honorable members of this Subcommittee, my name is Brad Smith, and I am Senior Vice President and General Counsel of Microsoft Corporation. Thank you for the opportunity to provide Microsoft's perspective on these important issues. Before going into detail on the topics of search advertising and the agreement between Google and Yahoo!, which together control approximately 90 percent of search advertising, I thought I would begin by providing an overview of Microsoft's perspective on the deal.

I. SUMMARY OF WHY THE GOOGLE-YAHOO! DEAL WOULD REDUCE CHOICE AND INNOVATION AND LEAD TO HIGHER PRICING.

Less than a year ago, I appeared before the Congress to discuss the serious challenges facing the state of competition in the critical space of online advertising. In the intervening months, I regret to report that the state of competition clearly has not improved.

Although the online world is still in its relative infancy, we find ourselves at a crossroads. Competition in search and search advertising is critical to our society and economy. The issues before this Subcommittee today could very well shape the extent to which the Internet continues to develop into a thriving marketplace of commerce and ideas.

Specifically, we are here today because Google and one of its chief rivals, Yahoo!, have teamed up in a deal that affects approximately 90 percent of all search advertisements sold in this country. If permitted to proceed, we believe the Google/Yahoo! agreement would effectively create a monopoly in search advertising — to the extent one does not already exist — and further reduce competition.

To be clear, obtaining a high market share through ingenuity and hard work is how our system rewards those businesses that succeed in a competitive marketplace. Indeed, Microsoft is quick to recognize that a company like Google has worked hard to achieve many of its great accomplishments. However, compared to earned success, achieving or entrenching dominance through collusive agreements or other artificial means undermines competition.

Microsoft believes the Google/Yahoo! deal harms competition in several critical ways. Advertisers and online content providers would be harmed through price coordination that will establish higher prices and limit choice. Consumers would be put at risk as Google expands its ability to collect the personal information of users passing through its search gateway. On an even more fundamental level, Google's monopoly power would increase its ability to shape what people get to see and experience online.

Ultimately, the long-term ramifications of this deal would undermine the very diffusion of power the Internet is supposed to promote. There is the very real prospect that we would regress to the days when information and communications were in the hands of only a few national, broadcast television companies — a state of affairs antithetical to the Internet's core purposes, principles, and promise.

Before addressing Microsoft's specific concerns with the deal, it is also worth pausing to recognize why we are here today. The central question faced by this Subcommittee and regulators is *not* whether this deal is good or bad for Yahoo!'s search advertising business. The antitrust laws exist to protect competition, not individual competitors. Thus, the central question is whether the deal between Google, which accounts for about 70 percent of the search advertising market, and its main search rival Yahoo!, with around 20 percent market share, would harm competition.

Moreover, although we would welcome a discussion about the pro-competitive benefits of a Microsoft/Yahoo! transaction at the appropriate time, it is little more than an academic question at this stage. The Google/Yahoo! agreement is the one that Yahoo! has chosen to pursue. It is the Google/Yahoo! deal that is under investigation by the United States Department of Justice and numerous state attorneys general, and it is the Google/Yahoo! deal that, we believe, poses an immediate and substantial threat to competition.

II. COMPETITION IN SEARCH AND SEARCH ADVERTISING IS CRITICAL TO OUR SOCIETY AND ECONOMY.

A. Online Search Advertising Is Critically Important to the Internet and the Businesses that Use It to Reach Consumers.

Search engines are a critical gateway to the Internet and its almost limitless content and services. An estimated 65 percent of online shoppers conduct product research using search engines.[1] Search engines enable us to find the content we need and to harness the full power of the web. They are, therefore, critical to the growth and health of the Internet and to our broader economy, particularly as the Internet continues to grow as a destination for information, communication, and commerce. In May 2008, for example, there were *over 7.8 billion* search queries conducted in the United States.[2]

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[1] iCrossing, *How America Searches: Online Retail* at 2 (Sept. 24, 2007).

[2] Nielson Online, *May U.S. Search Share Rankings* (June 19, 2008), *available at* http://www.nielsen-netratings.com/pr/pr_080619V.pdf.

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Online advertising is the "fuel" that drives all the Internet has to offer. Advertising, for example, is what enables search engines to provide their important services for free. It also enables content providers on the web, such as MSNBC.com, ESPN.com, and FoxNews.com, to offer free content and services. Online advertising expenditures likely will exceed $27 billion in the United States in 2008 and are expected to grow to about $42 billion by 2011.[3]

Search advertising, in particular, offers a unique value proposition to advertisers because it allows them to target ads to the real-time desires of a user. And the advertiser typically only pays for the ad if the user actually clicks on it. This one-two punch provides compelling value that, at least today, allows small, medium, and large businesses alike to succeed using the power of search ads. In 2007, approximately $8.6 billion was spent on search advertising in the United States.[4]

B. Increasingly, One Company Controls the Search "Gateway": Google.

Google operates the dominant search engine and is the dominant provider of search advertising in the United States. It accounts for approximately 70 to 75 percent of search advertising revenue (and roughly the same number of search queries).[5] Yahoo! is Google's next closest search advertising competitor with around 20 percent market share. Microsoft is a distant third with less than 10 percent. In just 10 years or so, Google has amassed a market

[3] EMarketer, *Search Marking, the Behemoth Online Advertising Format* (Feb. 2008), *available at* http://www.iab.net/insights_research/iab_research/1675/334424.

[4] *Id.*

[5] *Id.* (estimating that Google raked in 75 percent of U.S. paid search advertising in 2007); comScore qSearch, All qSearch Properties media category (May 2008) (with Microsoft analysis) (listing Google's U.S. query share, along with its partners, at 75 percent in May 2008; noting that Yahoo!'s query share in May 2008 was 17 percent and Microsoft's was 7 percent).

capitalization of around $166 billion, nearly *all* attributable to its search advertising business. To put this in context, Google's market capitalization is as big as Coça-Cola and Boeing *combined*.[6]

Last year, the FTC put to rest any doubt as to whether Google controls the search gateway in its decision on the Google/DoubleClick transaction. Following its lengthy and thorough investigation, which involved a review of Google's internal documents (likely at least a million pages of Google's own documents) and discussions with scores of advertisers and industry participants, the FTC reached an important conclusion: Google is "the dominant provider" in the search advertising market.[7] As a fundamental matter, the FTC concluded that other forms of advertising (online or offline) should not serve as a basis to eliminate concerns about Google's dominance in search.

C. Overview of Search Advertising.

1. The Mechanics of Search Advertising.

Search advertising refers to the text links that typically appear at the top and right side of search engine results pages. Search engines interact with a search advertising platform. Both technologies work together to provide a seamless experience to the user, but work differently behind the scenes and play very different roles in this important ecosystem.

After we enter a query into a search engine, we actually see two different types of results on the same page. The first are the search query results themselves, also called "algorithmic" search results. These unpaid results are generated by the search engine's index of online content and attempt to list the websites the engine decides are most relevant to the user's search query.

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6 Drake Bennett, *Stopping Google*, BOSTON GLOBE (June 22, 2008), *available at* http://www.boston.com/bostonglobe/ideas/articles/2008/06/22/stopping_google/.

7 Statement of the FTC Concerning Google/DoubleClick at 3, FTC File No. 071-0170 (Dec. 20, 2007), *available at* http://ftc.gov/os/caselist/0710170/071220statement.pdf.

The second type of search results are links to *paid advertising* that typically appear just above or to the right of algorithmic search results and are delivered by the search advertising platform. Advertisers typically pay only when users click on these textual ads.

Although search ads appear to be quite simple, offering them is a huge and complex business. Operating a search engine and a search advertising platform can require billions of dollars to maintain the necessary infrastructure. That is why there are just three companies participating in this market today — Google, Yahoo!, and Microsoft. When it comes to search *advertising*, alternatives are *not* just one click away. This is a tough business in which to succeed. It is a business where size and "scale" make all the difference. Thus, the bigger the leader gets, the harder it is for everyone else to compete.

2. *Google has the ability to influence and manipulate pricing of search advertising.*

Google, Yahoo!, and Microsoft use a process to determine which search ads to place and in which order. This process involves an auction among advertisers. Google has suggested that it does not influence pricing of search advertising because it determines the prices through this auction.[8] Contrary to Google's claim, however, the advertiser auction on its system is no ordinary auction where buyers and sellers set price without active intervention of the auctioneer. Rather, Google has the ability to influence and determine prices through various means, such as minimum prices and secretive "quality scores." In fact, in the Google auction, the highest bidder in the keyword auction may not win, and what an advertiser "bids" is not necessarily what an

[8] Verne Kopytoff, *Thwarting Microsoft Lifts Google*, S.F. CHRON. (May 9, 2008) (reporting that Google CEO Eric Schmidt emphasized that "Google would not set the prices for ads on Yahoo! because those prices are determined by an auction.").

advertiser actually "pays." Indeed, many advertisers have complained about the lack of transparency in Google's auction process.[9]

III. The Google/Yahoo! Agreement.

A. Overview of the Agreement.

The events leading up to this hearing are well known. Namely, there exist serious and important questions regarding the effect of the June 12, 2008 advertising agreement between Google and Yahoo!. Under the agreement, Yahoo! will be able to place search and contextual advertising from Google on Yahoo!'s properties in the United States and Canada. In exchange, Google has agreed to give Yahoo! an undisclosed portion of the revenue from Google's ads shown on Yahoo!'s search pages. The deal has an initial four-year term and can last as long as ten years.[10]

Google and Yahoo! have not disclosed their agreement to the public.[11] Instead, they have provided selected details in public statements and mandatory filings with the Securities and Exchange Commission ("SEC").[12] While Google and Yahoo! have suggested that Yahoo! is not obligated to place any Google ads next to Yahoo! search results, they are silent on whether there

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[9] *See, e.g.*, Miguel Helft, *The Humans Behind the Google Money Machine*, N.Y. TIMES (June 2, 2008) ("Many [advertisers] say that despite efforts by Google to be more transparent, they remain in the dark about what goes on inside the company's ad machine.").

[10] The long-term agreement was the culmination of coordination between the two companies over the last several months, including a two-week "test" that allowed Google and Yahoo! to obtain information about their relative search advertising pricing.

[11] Indeed, Microsoft recently requested a copy of the agreement from both Google and Yahoo!. Neither company has responded.

[12] *See, e.g.*, Yahoo!'s 8-K (June 12, 2008). Illustrations submitted to the SEC by Yahoo! suggest that the exact same search ad in the exact same location could be sourced by Google over Yahoo! under the deal. What is clear is that there is a limited amount of ad space on each Yahoo! search results page, and Google search ads will frequently displace Yahoo!'s in the most valuable positions. Any advertising space used by Google, of course, is space that an advertiser could no longer purchase directly from Yahoo!.

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are limits to the amount of advertising from Google that Yahoo! could substitute for its own. In fact, there appear to be several incentives for Yahoo! to hand over more, not less, of its advertising sales to Google.[13]

Yahoo!'s President Sue Decker suggested during the company's June 12 investor call that Yahoo! will rely on whichever search ad(s) will fetch a *higher* price (i.e., "better monetize"). In essence, therefore, the deal effectively creates a "price floor" (i.e., Google's price) because there is no incentive for Yahoo! to sell its ad space inventory for less than Google's platform can realize.[14]

Yahoo! projects that the deal will generate additional operating cash flow of as much as $800 million per year from Google. This additional money presumably will flow from the pockets of advertisers — in many cases in the form of higher prices for the same ads they purchase directly from Yahoo! today.

Google and Yahoo! have not touted any benefits from operational integration between the companies.[15] This suggests that the Google/Yahoo! agreement is a bare marketing and pricing agreement between head-to-head competitors.[16]

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[13] The agreement provides for the payment to Yahoo! of a percentage of Google's revenues under the agreement, "with such percentage adjusting based on specified monthly gross revenues thresholds." Thus, the agreement may be structured so that Yahoo! has the incentive to shift more traffic to Google to earn an even larger cut of Google's growing revenues. In addition, according to the SEC filings, Google may terminate the agreement if certain revenue thresholds are not satisfied. Google's termination right provides a strong incentive for Yahoo! to continue to rely on Google's ads.

[14] Yahoo! estimated in an SEC filing a few months ago that Google's revenue per search is, on average, 60 to 70 percent higher than Yahoo!'s, which suggests that Yahoo! will want to cede control to Google for a fair number of Yahoo!'s advertisements. Exhibit 99.2, Yahoo! Investor Presentation at 14 (Mar. 2008) *in* Yahoo! Current Report (Form 8-K) (Mar. 18, 2008).

[15] Ms. Decker has explained that Yahoo! will not generate any costs savings as a result of the deal. *See* Transcript of Yahoo!'s June 12, 2008 Conference Call to Discuss Advertising Agreement with Google at 5. Similarly, Google Chairman and CEO Eric Schmidt explained there will be little to no improvement to

Both Google and Yahoo! have presented the deal as "open," although it hardly seems to be so in any practical way. In the software industry, the word "open" is often synonymous with "interoperability," which is not going to occur as a result of this agreement. Notably, it is a "one-way" agreement — Google can sell search ads on Yahoo!, but Yahoo! cannot sell search ads on Google. Moreover, there is no reason to believe the same arrangement will work in practice for any non-Google competitor, as Google's typically higher auction prices invariably will trump the lower prices of Google's competitors.

Finally, Google has represented that this kind of arrangement is commonplace in many industries and has compared the deal to Toyota selling its hybrid engine technology to rival General Motors. This analogy simply does not hold water. Google is not selling Yahoo! a part (analogous to a hybrid engine) that Yahoo! needs to build a product (a completed car). Google is replacing Yahoo! as the seller of the product itself — search advertising. If anything, it is more like Toyota selling GM the whole car and the two companies agreeing to sell Toyotas in GM showrooms in instances where Toyotas can fetch a higher price! The reality is that GM and Toyota could no more enter into such an agreement than Google and Yahoo!. *This is anything but a standard supply agreement.*

Google's platform as a result of the deal. *See* Transcript of Google's June 12, 2008 Conference Call to Discuss Advertising Agreement with Yahoo! at 6-7.

[16] The antitrust laws treat such "naked" agreements among competitors less favorably than mergers or joint ventures that hold out the prospect for efficiencies, which could lead to the development of new technologies and products as well as cost savings.

IV. THE GOOGLE-YAHOO! DEAL WOULD REDUCE CHOICE AND INNOVATION FOR ADVERTISERS, CONTENT CREATORS, AND CONSUMERS AND LEAD TO HIGHER PRICING.

A. The Agreement Entangles the Dominant Provider of Search Advertising with Its Closest Competitor.

The Google/Yahoo! agreement contemplates significant, ongoing coordination between the dominant provider of search advertising and its chief rival. Together, Google and Yahoo! control an estimated 90 percent of search advertising, with Google alone accounting for over 70 percent. With search advertising fueling the anticipated doubling of online advertising over the next three years, the deal could make Google bigger than any newspaper chain or any television network and provide Google the largest concentration of advertising control in history.[17] The growing importance of the Internet, and media in general, makes this concentration of power all the more concerning.

B. The Agreement Harms Competition in Several Ways, All of Which Would Further Entrench Google's Dominance in Search and Reduce Choice.

Microsoft believes that the Google/Yahoo! agreement likely violates the antitrust laws in several fundamental ways. Some of the anticompetitive aspects of the agreement are discussed below.

First, the agreement reduces Yahoo!'s incentive to compete with Google. Because Yahoo! will share in Google's revenue, it will make more money when Google makes more money. Similarly, Yahoo! will make less money when Google makes less money. Thus, Yahoo!'s incentive to compete against Google following the deal will be reduced. In fact, any competitive decision that Yahoo! makes regarding pricing, innovation, or capital expenditures

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[17] Search advertising revenues reached $8.6 billion in 2007 and are expected to jump to almost $16.6 billion by 2011. That is comparable to both radio and cable advertising, whose revenues each totaled about $20 billion in 2007, but search advertising is growing much faster.

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will have to be weighed against the revenue that Yahoo! would receive from Google's higher profits. The antitrust laws have long disfavored agreements that result in incentives for competitors to "pull their punches" with one another. The concerns are particularly acute in instances where the two companies involved in the coordination account for such an enormous percentage of the market.

Second, this agreement increases the probability that Yahoo!'s search advertising platform will enter a downward spiral that will further weaken its competitiveness, particularly as Yahoo! funnels more search share to Google and as advertisers realize they can no longer get "discounts" on Yahoo!'s platform. In turn, this would reduce even further Yahoo!'s incentive to invest and compete in search advertising and would result in an even greater dependence on Google. Interestingly, an internal Yahoo! document from this past January contemplated some of these same effects when *Yahoo!* suggested that the deal before this Subcommittee today would be harmful to Yahoo! and result in Google having an "effective monopoly."[18]

Third, the agreement effectively establishes a *per se* illegal price floor. In explaining the deal, Yahoo!'s President stated that Yahoo! will rely on Google's ads when those ads command a higher price (i.e., "better monetize"). Quite simply, Yahoo! and Google are setting a "price floor" (i.e., Google's price) for ads on Yahoo!'s properties. Yahoo! will never have an incentive to sell an advertisement for less than Google is offering.

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[18] The Yahoo! document discussed whether Yahoo! would consider outsourcing search to Google and stated: "We are focused on long-term value creation rather than short term gains (*short term analysis of the revenue potential of outsourcing monetization may not take into account the longer term impact on the competitive market if search becomes an effective monopoly*)." *See In re Yahoo! S'holders Litig.*, Cons. C.A. No. 3561-CC (Unsealed First Am. Verified Consol. Compl. ¶ 94, May 12, 2008), *available at* http://www.blbglaw.com/complaints/YahooFirstAmendedVerifiedComplaint-Unsealed-5.12.08.pdf.

The legal precedent in this area is straightforward. In *United States v. Socony-Vacuum Oil Co.*, a case taught in law schools across the country as "black-letter law," the Supreme Court established that agreements between competitors that stabilize price or establish a "price floor" constitute *per se* illegal price-fixing under the antitrust laws — regardless of justifications, intent, or the mechanism used to effectuate the fix.[19] In that case, large gasoline refiners effectively created a price floor for gasoline by agreeing to buy from smaller refiners cheaper "distressed" gasoline that otherwise would have reduced prices.

Similar to the situation in *Socony-Vacuum Oil*, Google is effectively agreeing to buy up Yahoo!'s ad space wherever that ad space would otherwise be available at lower prices. As a result, keywords that cost advertisers less on Yahoo!'s platform before the deal would no longer be available, because those advertisers would have to pay the higher price at which those keywords are sold by Google in order to advertise on Yahoo!. Put another way, advertisers would no longer get the "bargains" they have enjoyed as a result of competition between Yahoo! and Google.

C. The Loss of Competition From the Agreement Would Harm Consumers, Advertisers, and Content Providers in Several Ways.

The reduction in competition resulting from the agreement would have important and longstanding effects on the search marketplace, those that rely on it, and the Internet as a whole. For example:

The agreement will reduce choice and place even more power and control over a major industry and online content in Google's hands. Google will control even more of consumers'

[19] *Per se* offenses are considered so egregious that courts are not permitted to assess the justification offered by the two parties entering into the agreement. The fact that the agreement exists, by itself, is enough to condemn the agreement as illegal.

personal information. A Google-Yahoo! partnership not only gives Google the ability to place advertisements next to nearly 90 percent of online search results — it also gives Google access to up to 90 percent of all search queries and online behaviors, including the sites consumers click on and, in some cases, what they do on those sites. Similarly, with weaker competition, one has to wonder what would constrain Google's already questionable privacy practices relating to the reservoir of personal data it holds. Even today, Google has shown a willingness to push the line when it comes to privacy. Indeed, only with substantial prodding did Google finally add a privacy link to its home page.

Content providers, which rely on neutral and competitive search in order to reach users through advertising and unbiased search results, will become more beholden to Google's power. Advertisers also will find themselves left with no choice but to place ads with Google, despite its non-transparent policies.

The agreement will result in higher prices for advertisers and content creators. As already discussed, the agreement effectively establishes a minimum price floor and otherwise reduces the incentives of Google's closest competitor to compete. The reduction in competition between Google and Yahoo! may also mean that web content creators would receive less money from Google or Yahoo! for placing toolbars and ads on their sites, which is an important source of revenue for many online businesses.

D. The "Non-Exclusive" Label Does Not Immunize the Agreement from the Antirust Laws.

Finally, both Google and Yahoo! have presented the deal as "open" and "non-exclusive" in the sense that it does not prohibit Yahoo! from running ads served by its own search advertising platform or third parties. Even putting aside the significant incentives built into the agreement to funnel ads to Google, such labels carry little weight. Antitrust courts and regulators focus on the substance and ultimate effect of agreements, rather than their form or labels. In their own guidelines (and enforcement history), regulators recognize that non-exclusive arrangements can violate the antitrust laws if they result in one firm maintaining or obtaining monopoly power, or, more generally, if the arrangement results in conditions that are harmful to competition.[20]

V. CONCLUSION.

I am fully aware that the presence of Microsoft at this hearing must strike some as ironic, given our own antitrust history. There also is no doubt that we have an interest here as a competitor to Google and Yahoo!. Given the concerns that have been expressed by others, the Department of Justice will hear from several advertisers, agencies who place advertising on behalf of businesses, consumers, and, of course, the people who create content and services that are freely available on the Internet. Already we have heard from advertisers — many of them Google's own customers — about the negative impacts of the company's deal with Yahoo!.[21]

Ultimately, it is well recognized that Google could not acquire advertising space from Yahoo! as part of an acquisition. When it comes to the issues before this Subcommittee, Google should not be allowed to achieve an outcome through an agreement that it would not be

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[20] *See, e.g.*, *APRIL 2000 DOJ/FTC ANTITRUST GUIDELINES FOR COLLABORATIONS AMONG COMPETITORS* at § 3.34 ("The Agencies look to the competitive benefits and harms of the relevant agreement, not merely the formal terms of agreements among participants."); *id.* at § 3.34(a) ("The Agencies inquire whether a collaboration is non-exclusive in fact as well as in name and consider any costs or other impediments to competing with the collaboration.").

[21] Digital marketing executives have voiced significant concern, such as Brian Waldman, a Boston-based Internet marketer (*see* Betsy Schiffman, *Yahoo Customers Pan Google Ad Deal*, *WIRED EPICENTER BLOG* (June 13, 2008), *available at* http://blog.wired.com/business/2008/06/marketers-see-l.html), Arjo Ghosh, CEO iCrossing (*see Sarah Arnott, Discontent flares over Google's 'dominance,' THE INDEPENDENT* (June 16, 2008), *available at* http://www.independent.co.uk/news/business/news/discontent-flares-over-googles-dominance-847920.html), and Bryan Wiener, CEO 360i (*see* Abbey Klaassen, *Google May Gain $1 Billion in Yahoo Ad Pact, Advertisers Suspect Prices Will Increase*, *ADVERTISING AGE* (June 16, 2008)).

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permitted to achieve otherwise. The effect of this agreement would be to further entrench the control of the dominant supplier of search advertising and, in the process, reduce choice and innovation and increase prices. As a result, we believe the Google/Yahoo! agreement raises some very serious concerns and may very well be illegal under the antitrust laws.

Mr. Chairman and members of the Subcommittee, thank you for the opportunity to appear before you today.

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